EBRI

SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES?

An EBRI Policy Forum

EMPLOYEE BENEFIT RESEARCH INSTITUTE

Employee Benefit
1817 Research Institute
c.2
Should pension
assets be managed
for social/political

EBRI

E.B.R.I.
Library

SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES?

An EBRI Policy Forum
December 6, 1979
Edited by:
Dallas L. Salisbury

EMPLOYEE BENEFIT RESEARCH INSTITUTE

© 1980 - Employee Benefit Research Institute
1800 M Street, N. W.
Washington, D.C. 20036

No part of the papers in this book by James D. Hutchinson and Charles G. Cole, Roy A. Schotland, and Karen W. Ferguson may be reproduced without permission in writing from the Institute. Permission to quote from materials in this publication is granted when due acknowledgement is made. The views contained in publications of the Employee Benefit Research Institute are those of the author or authors and do not necessarily reflect the views of the staff, officers, trustees, or members of the Employee Benefit Research Institue.

Library of Congress Catalog Number 80-65232
Printed in the United States of America

EDITOR'S PREFACE

Pension plans, public and private, now have nearly 600 billion dollars in assets. These assets are continuing to grow at a significant rate, and represent a major portion of the Nation's capital stock available for investment. Pension funds are reported to own over 25 percent of all publicly held corporate stock and 40 percent of corporate debt, and these percentages are expected to grow.

Such a large pool of capital cannot help but attract attention. There have been numerous occasions when specific, non-traditional uses have been advocated. While the concept of "social investments" has been discussed for many years, only recently has it simultaneously been the subject of legislative proposals and policy debate at the federal, state and local levels. Now, numerous organizations, including the President's Commission on Pension Policy, have highlighted social investing, ownership and control of pension assets, and the setting of investment objectives as areas in which they will undertake studies and formulate recommendations.

The literature available on "non-traditional" or "social" investments is limited, with only one book focusing directly on the subject of social/political investing of pension assets. That book argues strongly for political approaches. Many articles have appeared in the "trade" press on the subject, and books on subjects such as institutional investing, the setting of investment objectives, ethical investing, and institutional/ corporate social responsibility, provide very appropriate analogies.

The absence of a single book which neutrally treats all major aspects of social/political asset management makes it very difficult for policy makers and interested persons to assess the area quickly. The decision to sponsor a Policy Forum on the management of pension assets for social/political purposes was based upon perception of this need. Ms. Ferguson, Mr. Hutchinson and Mr. Schotland agreed to participate and prepare papers in July, 1979. The group was guided by a common description of what was desired, and met between July and December for discussion. The papers and proceedings present a comprehensive overview of the area. Part I presents papers prepared for the Forum. These papers represent

the submissions of the respective authors in their entirety. Part II presents questions and answers from the Forum which have been divided into sections by subject. Part III presents partial proceedings from December 10-11, 1979 hearings on this subject held by Study Group III of the President's Commission on Pension Policy. Part IV includes appendices with background information for those wishing to do additional work in the area.

EBRI believes that this book will be of general benefit to concerned professionals and decision makers in both the public and private sectors. It should provide the background needed to evaluate the many studies and reports that will be issued in the months and years ahead. I wish to thank all those who gave so much of their time to make this Institute project possible.

Dallas L. Salisbury
January, 1980
Washington, D.C.

ABOUT THE AUTHORS

Lisle C. Carter is President of the University of the District of Columbia and a member of the President's Commission on Pension Policy. Mr. Carter holds numerous appointments, and has written numerous articles.

Karen W. Ferguson is Director of the Pension Rights Center in Washington, D. C. She is a frequent speaker on issues affecting employee benefit plan participants and beneficiaries.

James D. Hutchinson practices law in Washington, D. C., where he is a partner in the law firm of Steptoe & Johnson. He has held senior positions in government, including service as Administrator, Pension and Welfare Benefit Programs, United States Department of Labor. He is a member of the Advisory Board for the BNA Pension Reporter, the U. S. Chamber of Commerce Employee Benefits Committee, an Advisory Director of the International Foundation of Employee Benefit Plans, and has authored numerous articles and testified before a number of Congressional Committees on employee benefit issues.

Dallas L. Salisbury is Executive Director of the Employee Benefit Research Institute. He has held senior positions in the benefits area with the U. S. Department of Labor and the Pension Benefit Guaranty Corporation, is a frequent speaker on benefit topics, and has authored numerous articles in the area.

Roy A. Schotland is Professor of Law at Georgetown University. He has held positions as Associate Dean, Georgetown, Professor of Law at the University of Virginia and the University of Pennsylvania; and has practiced law in New York City. He is Chairman of the Twentieth Century Fund Project on Conflicts of Interest in Securities Markets and is a member of the American Law Institute, the Advisory Board for the BNA Pension Reporter, the Comptroller General's Panel on Banking Regulation, and has authored numerous articles and testified before a number of Congressional Committees on employee benefit issues.

CONTENTS

	Page
EDITOR'S PREFACE	iii
ABOUT THE AUTHORS	v
CONTENTS	vii
SUMMARY	ix
PART I: FORUM PAPERS	
Should Pension Assets Be Managed For Social/Political Purposes? - An Overview Dallas L. Salisbury	4
The Issue of National Policy Lisle C. Carter, Jr.	20
Legal Standards Governing the Investment of Private Pension Capital James D. Hutchinson Charles G. Cole	28
The Advocate's Arguments: A Review and Comment Karen W. Ferguson	94
The Opponent's Arguments: A Review and Comment Roy A. Schotland	106
PART II: FORUM PROCEEDINGS	
Introduction	200
The Legal Framework	202
The Legal Setting and Risk	216
The Advocate's Position	222
Purposes of Pension Asset Investments	232
The Issue of Investment Return	242
Points of Consensus	252
Asset Ownership, Plan Type, and the Efficient Market	270
Pension Plan Termination Insurance	284

Page

PART III: HEARINGS OF THE PRESIDENT'S COMMISSION ON PENSION POLICY

The Legal Setting 292

The Participants' Role in Setting Investment Policy 312

The Targeting of Pension Capital 320

The Use of Pension Assets to Promote Union Interests 336

The Portfolio Impact of Non-Traditional Investments 348

PART IV: APPENDICES

Appendix A: Forum Participants 362

Appendix B: Sources of Information 366

Appendix C: Bibliography 372

SUMMARY

"Social investing" is a phrase used to refer to a number of economic and investment policy issues currently being discussed within the pension field. The issues and explicit demands tied to them could have an impact upon everyone associated with pensions, from plan participants to employee benefit professionals. An overall understanding of what social investing implies must exist, if the issues and demands are to be dealt with rationally. This overview seeks to provide a beginning which, along with the specific papers that follow, and the Forum transcript, will establish a basis for that understanding.

Participants in the Forum reached concensus on two significant points. First, they agreed that the primary purpose of benefit programs should be to serve participants as participants. Second, they agreed that when comparable risk/return investments are available it should be possible to consider secondary factors.

Participants split dramatically on what has become a clear point of departure for social investment: accepting reduced risk/return investments knowingly in order to achieve non-benefit objectives.

Considerations for Analysis

The necessary starting point for analysis given the consensus points noted above, is not as difficult to pinpoint as some have believed. The knowing acceptance of inferior risk/return investments is clearly the central issue. Such investments are referred to in the Forum as "political", "socially dictated", and "divergent". The second issue is whether comparable investments can be discerned based upon social factors. Such "comparable" investments are referred to in the Forum as "social", "socially dictated", and "moderately divergent". Within the framework of such labels a number of points have arisen in the past that were considered in what follows, including:

- Discussion encompasses both political and social motivations and clearly differentiates the two;
- Discussion encompasses (1) applications which produce an economic return equal to other investment alternatives; and (2) applications which lead to an economic return lower than other investment alternatives;

- Discussion includes an assessment of strategies that are designed to provide direct benefits to non-retired participants (e.g., encourgage unionization or localized economic development);
- Discussion encompasses strategies that are designed to expand capital placement in particular sectors (e.g., housing, venture capital, small businesses); and
- Discussion encompasses strategies that are designed to punish or reward for particular forms of behavior (e.g., pollution, racial policies).

The Forum reviewed these issues and provided an assessment of factors such as:

- The legal environment and how it differs for various management approaches advocated;
- Who bears the risk for losses (and possible increased transaction costs);
- Administrative feasibility;
- Implications for trustees and other fiduciaries;
- Differences, if any, between implications for public and private funds;
- Differences, if any, between various social and political approaches;
- The arguments and motivations of opponents and proponents; and;
- Questions of capital market efficiency.

Legal Issues

The legal environment, present under the common law, but highlighted by enactment of the Employee Retirement Income Security Act of 1974 (ERISA) and existing state and local legislation, consists primarily of legal constraints on behavior. The fiduciary responsibilities of plan trustees, especially those based upon the ERISA prudent man rule, are viewed as creating difficulties in justifying investment criteria other than maximizing return at a reasonable risk. Still, there are arguments that social and political investments, at lower returns, can be prudent. James Hutchinson's paper provides a comprehensive legal review, which when combined with extensive discussion in the transcript covers the full range of issues.

Proponents

Advocates of social investing have cited moral, humanitarian and political reasons when calling for increased social investments. Increased emphasis has also been placed on investments designed to benefit plan participants directly. Two examples are investments by joint-trust plans which encourage unionization, and investments to encourage economic development in areas where plan participants live. Investment advocacy of this type has been viewed as sometimes having both political and social components. The extreme argument is for conscious acceptance of a reduced net-return in favor of other objectives. Ms. Karen Ferguson's paper provides a review of the "advocates" arguments as well as a personal assessment. The transcript includes statements of other advocates which serve to provide a comprehensive picture.

Opponents

Achievement of the proposed social/political objectives may involve costs and/or increased risks to other individuals. Undertaking investments at less than competitive returns or at high risk could affect fund performance. Concentrating funds in either geographical areas or specific types of investments may violate reasonable diversification principles. Some approaches may present problems due to increased transaction costs or restricting trustee discretion beyond what is reasonable. Banning investments in certain areas which may offer attractive returns could affect optimum fund performance. Opportunity costs associated with the inability to act rapidly could further dampen investment performance.

Serious questions arise concerning who should bear the potential costs associated with such investing. Should the employer? The employee? The retiree? What decision rules should be used in distributing costs? Who should develop the rules? Many of these issues relate to the type of investment objectives set for the plan. In that context, the issue becomes one of whether or not such objectives can be effectively implemented (and at what cost).

Implementation problems might occur in administration, oversight of investments, performance evaluation, investment selection, policy development, and of conflicts of interest. Other unforeseen implementation problems could also occur. The extent of implementation problems, were they to exist, would depend upon the percentage of pension fund assets allocated towards non-traditional investments, the nature of the rules governing the investments (e.g., inclusion or exclusion), and the time frame in which portfolio changes are required to be made. Roy Schotland's paper presents the arguments and concerns of the "opponents" as well as a personal assessment.

Future Policy

Finally, legislative initiatives designed to increase non-traditional investments are being introduced at the local, state, and federal level. Whether the thrust is to relax ERISA constraints or foster action through government incentives, the intent is to attract pension funds to investments with specific social/political consequence. Employee benefit professionals, particularly investment managers and other plan fiduciaries, will have to decide how to respond to special incentives should they become available. A rapid positive response might accelerate the social/political investment movement. A continued reluctance to invest might result in more mandatory legislative initiatives. Consideration must also be given to government policy beyond the present legal framework. Dr. Lisle Carter focuses on the question of formulating policy in his presentation.

Current studies by the Urban Institute, the Institute for Policy Studies, the Council on Economic Priorities, and the Wisconsin Institute for Public Policy may shed additional light on the question of managing pension plan assets for social/political purposes.

Political debate sparked by the case made for increasing social/political investment by Jeremy Rifkin and Randy Barber in their book _The North Will Rise Again_, may serve to indicate the strength and appeal of the social/political investment movement. Given the uncertainty of long-term public policy in this area, employee benefit professionals have time to gain a clear understanding of the issues and to participate in the debate. Developing an understanding of the issues will make adjustment to the future environment less difficult.

Conclusion

Final decisions on the appropriateness of the new investment strategies discussed herein could have a major impact on future retirement income security in the United States.

PART I
FORUM PAPERS

Should Pension Assets Be Managed For Social/Political Purposes? An Overview

Dallas L. Salisbury

INTRODUCTION

William Winpisinger, President of the International Association of Machinists, is ready to take drastic action over pension fund investment policy.[1]

Lloyd McBride, President of the United Steelworkers of America, intends "to make control over pension fund investments a bargaining point in future negotiations."[2]

Jeremy Rifkin and Randy Barber, in their recent book, The North Will Rise Again, conclude: For better or for worse, much of the future hopes and prospects of the union movement will rise or fall with the future economic and political prospects of the Northeast and Midwestern states. That future, they contend, is closely tied to the control and activist use of pension funds.[3]

The above statements fall under the umbrella of an area commonly referred to as "Socially Responsible Investing of Pension Fund Assets." Taken alone, one might conclude that the pension industry is facing a policy crisis; but is this true? Are demands coming only from persons seeking new sources of capital as the federal government adjusts to limited real growth? Or, does the demand have a broad common support base? Are the recent union demands, articles, and book, the opening salvo in a major policy challenge to the way hundreds of billions of dollars in pension assets are managed? Or, has the issue already passed? How much of what is being called for is truly different than what is already common practice? Are the advocates looking for social investing, political investing, or both?

The possible effects of the debate over social/political management of pension assets extend well beyond the community of employee benefit professionals. A substantial majority of American workers are covered by either a public or private pension plan (other than Social Security). Pension funds have become the dominant source of external capital for American industry. Pension funds are a major source of manageable assets for banking, insurance and investment management firms. To the extent that fundamental policy shifts affecting pension investments occur, all parties with pension interest will be affected. Thus, our interest in the question: Should pension assets be managed for social/political purposes?

Senator Howard Metzenbaum (D-Ohio) believes that the issue will be with us for some time. At a recent Senate hearing, he stated:

> I believe that this trend, this questioning of the process by which pension fund investmetns are made is likely to continue to gather strength, and I believe further that Congress will have to address the complex issues this trend will inevitably bring to the floor.[4]

It is too early to tell if Senator Metzenbaum and others with similar concerns are correct. If they are, then it is crucial that employee benefit professionals and other persons clearly understand what "socially responsible investing" means; how, if at all, it could be done; who or what would be affected; and how they would be affected. Only with a thorough understanding of the issues and consequences will persons be in a position to influence future policy.

SOCIALLY RESPONSIBLE INVESTING: WHAT DOES IT MEAN?

The investment management approach most frequently followed, including pre-ERISA, has been to judge investment decisions on maximizing return at an acceptable level of risk. The justification for this approach is that it provides maximum retirement benefit security for plan participants. This has traditionally been viewed as a social goal sufficient unto itself. Today, some activists are challenging this belief. They are demanding that other considerations be added to, and possibly dominate, economic return.

Even among the activists there has been limited common definition. To sort out the arguments of proponents and opponents this Forum considers:

- the legal environment and how it differs for various management approaches being advocated;
- who bears the risk for losses (or possible increased transaction costs);
- administrative feasibility;
- implications for trustees and other fiduciaries;
- differences, if any, between implications for public and private funds;
- differences between various social and political approaches; and
- questions of capital market efficiency.

To aid analysis, the area of social investments can be broken along two primary lines.

- First, the desire to undertake investments with the purpose of bettering society as a whole; net return (return adjusted for risk) being comparable among the alternative investments.

- Second, the desire that investments be undertaken for strategic reasons--that is to benefit plan participants (or some other specific segment of society) other than as plan participants (e.g., maintaining jobs, increased unionization); net return (return adjusted for risk) the strategic investments frequently being lower than alternative investments.

These two desires may be mutually exclusive, and it is useful to distinguish between them. The former might be reasonably viewed as social; the latter as political. Jim Hutchinson refers to the former as "socially sensitive"; the latter as "socially dictated". Roy Schotland refers to the former as "moderately divergent"; the latter as "divergent". The central question of the social investing debate is whether net return should ever be knowingly sacrificed to achieve an objective other than what is in the interest of participants as participants.

Terminology

The strongest advocates of social investing argue that economic return should be secondary to achieving "social" results ("political", "socially dictated", or "divergent"). This view is set forth forcefully by Barber and Rifkin, and it is this view that has elicited the strongest response. Consistent with this approach, an interesting classification system has been set forth by Marc Gertner to aid in discussing arguments for accepting economic loss in order to achieve social/political benefits. He described socially responsible investments "as those investments which: (1) carry a lesser rate of return and/or (2) have a lower credit rating and quality and/or (3) have less liquidity or marketability than other forms of investment or specific investments readily available in the market place, but which will: (1) create employment opportunities for plan participants and/or (2) have a greater social or moral quality."[5]

For Gertner, "where relative return and risk factors are equal, the question of social desirability does not arise."[6]

Many commentators, however, do not agree with the advocacy of Barber and Rifkin, or the conclusion of Gertner. Most witnesses at recent Congressional hearings argued that a good deal of "social investment" could and should take place without hurting returns. These commentators do, however, tend to advocate "social" (e.g., housing) rather than "political" (e.g., unionization) objectives.

The moderate approach regarding compatability of return and social motivation, not political, was directly touched upon in a recent paper by Richard Parker and Tamsin Taylor:

> "Because of the issues involved, and the participants in the debate, the issue of 'social responsibility' has more and more come to be seen as one in which a trade-off is involved: most simply, one between 'yield' and 'morality'. That is, both sides in the debate have frequently posed the choice between acting responsibly and acting profitably. What should become evident....is that no such trade-off need be made. In fact, because of several profound economic changes in the past few years, social responsibility and profitability may now be more compatible than ever before. But because of the emotions generated, many participants have ignored such a conclusion."[7]

The papers prepared by Messrs. Carter, Hutchinson, Schotland and Ms. Ferguson present arguments consistent with the Taylor hypothesis. The papers set out "social" classifications where return is not sacrificed, and others where it is.

Due to the central focus on the issue of return in the social investment debate, the term "net return" is important. Economists usually break a projected return into three major components: (1) a risk free return on capital; (2) a component due to estimated rates of inflation; and (3) a premium for risk inherent in particular investment. Some component of risk is present in all investments, but some social/political investment management advocates argue that investments with yields equal to the general market are necessarily prudent and competitive. This would not seem to be the case if the risk associated with the social investment were greater than that of the traditional investment. A risk premium dramatically above the market rate might be necessary before the probable net return on two such investments could be considered equal. In this context, many advocates question the base principles of modern economic theory: is there an "invisible hand"? Should one rely upon the theory of efficient markets?

Efficient market theory has been set forth by many opponents as the primary reason for many of the economic and labor trends advocates wish to reverse. To what degree does government regulation of plans "distort" the efficient market? To what degree would new social/political management criteria exacerbate or counteract distortions already present due to government guarantees, government investment programs, subsidized interest rates and tax policies? Does government action of the past justify new "incursions"?

Approaches

A specific approach under the umbrella of "social investing" is increased diversification of pension fund investments. This is normally referred to as "inclusion". Rifkin and Barber say that

"between 1962 and 1975, 87 percent of all the money managers performed below the Standard and Poor's index", and they reason that inclusion will not lower actual return (some experts question these figures).[8]

Pressure for movement to investments other than stocks and bonds is part of the advocates "inclusion" position. For example, social advocates call for increased investment in housing mortgages and low-cost housing for the poor and the elderly. They argue that mortgage returns are attractive and risks are not exceptional. Do housing mortgages differ from investments in low-cost housing for the poor and the elderly? There is also pressure for pension funds to increase investments in small businesses ("venture capital"). In an effort to induce pension funds to "diversify", Senator Gaylord Nelson (D-Wisconcin) recently prevailed upon the Department of Labor to issue new regulations affirming that the interpretation of prudence extends to a wider array of investments than stocks and bonds.[9] Do these regulations change anything?

Private plans have shown an increasing interest in real estate, foreign securities, and equity accounts.[10] Do such changes constitute inappropriate investment? Does it matter whether the decision made was based upon previously agreed to investment objectives or third party pressure?

The advocates also set forth arguments for "exclusion"; that is, avoiding investments in companies that are involved in a certain activity (e.g., work in South Africa, OSHA or EEO violations, nonunion). The issues include those noted above for inclusion and others:

- If the investment is competitive, is there any reason to be concerned (i.e., no change in return, or liquidity, or the risk factor)?
- what are the consequences if the range of acceptable investments narrows to the point of limiting trustee discretion?
- what are the consequences if the investment objectives require divestiture?
- if there are increased transaction costs or trading losses, who should be responsible for bearing the burden?

To date, "social investment" has been used to mean many things to many people. In spite of the many ways it is used, it has become a code word, for many, for the political and the illegal. To generalize may well not be fair or wise. The papers by Roy Schotland and Karen Ferguson provide an effective presentation of positions and perspectives. The questions and answers in Parts II and III provide substantial clarification.

CAN A PRUDENT MAN SOCIALLY/POLITICALLY MANAGE?

Under the Employee Retirement Income Security Act of 1974 (ERISA), fiduciary standards were perceived by many to have been measurably tightened for private plan trustees.[11] Many persons believe that ERISA did not generally change the standards, but that it did change the public's awareness of the standards through the addition of personal liability.[12]*

These standards are commonly referred to as the "prudent man" constraints and may be summarized as follows:

> ...(A) fiduciary shall discharge his duties... solely in the interest of the participants and beneficiaries and--
>
> (a) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (b) with the care, skill, prudence, and diligence under circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (c) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to so so; and
>
> (d) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title.[14]

Upon the enactment of ERISA, trustees feared that taking factors into consideration other than immediate net return on the individual investment might not qualify under the "exclusive benefit to plan participants and their beneficiaries" covenant.[15] But subsequent interpretation of the Act has indicated that such investments would qualify.[16]

While the guidelines are viewed as being strict, experts feel that there is latitude available to trustees to include

---

*While ERISA does not apply to public plans, similar legislation is now being considered by the Congress. A 1977 report of the House Pension Task Force strongly argues for ERISA type fiduciary standards for public trustees as well.[13]

policy considerations after they are satisfied that net return on alternative investments would be equal. This position seems to be held by government pension regulators, as exhibited by recent Department of Labor Regulations and Congressional hearings.

A number of specific legal questions arise upon review of this information:

- if the legal experts are correct, how many "socially responsible" investments would be proper?
- Can extra expenses, however, be justified?
- Can "inclusion" be viewed as easier than "exclusion"?
- What are the legal applications in the areas of securities, antitrusts, discrimination, collective bargaining, etc.

Litigation and Legislation

Increasingly, activists are challenging the view that prudent man and common law "constraints" prohibit active social/political investing, even if the investment is not economically competitive and does not result in undue concentration of plan assets.[17] The extent to which this view is correct and can be implemented is open to question. For example, in the court decision of _Blankenship_ v. _Boyle_ (329 F. Supp. 1089, D.D.C. 1971), the United Mine Workers are said to have consciously used pension funds to assist the union's efforts to force utilities to burn union-mined coal. The court ruled that the investment policy was clearly designed to "advance the union's interests and not the funds and that there had therefore been a breach of fiduciary obligation on the part of the trustees".[18] The union argued that its policy benefited the beneficiaries through the creation and preservation of jobs. The fact that many of the investments were not at competitive rates of return may have had a crucial impact on the ruling, but the court did not treat this issue directly.

In the _Withers et. al._ v. _New York Teacher's Retirement System_, the United States District Court for the Southern District of New York did not allow the pension plan to invest a large percentage of its assets in New York City bonds in an effort to keep the city from bankruptcy.[19] This decision suggested that the "prudent man" standard could be relaxed, in certain circumstances to benefit, even indirectly, the interests of current participants and not just those receiving retirement incomes.

Responding to New York City's financial crisis, the Congress passed P.L. 94-236 to allow five New York pension funds to buy New York City bonds without tax disqualification.[20] "The House Ways and Means Committee, in approving the bill, stressed it should not be interpreted as a precedent under which governments can use plan assets to assist cities in raising revenues during periods of a

city's financial crisis, even though such use of plan assets might violate the exclusive benefit or prohibited transaction requirements of the Internal Revenue Code".[21]

The fact remains that in a "crisis" (the plan sponsors and not the plans), a traditionally "imprudent" investment of pension fund assets was allowed by the Congress. Whether this New York City decision consitutes a precedent will become more apparent should other governmental units experience similar crises. One might note discussions that have taken place regarding the possible use of Chrysler Corporation pension assets to aid the company.

The argument that an economic "crisis" exists now in the Northeastern states is a major rationale behind the Rifkin and Barber arguments for social/political investing.[22]

- Is there enough of a crisis to justify the actions they advance?
- Is what they advocate the norm among social advocates?
- Were the political factors (e.g., unionization) set aside, would there be equal concern?

The debate over social investment of pension funds may have just begun. The issue of social investing was hardly debated during the legislation hearings that led to ERISA. Persons involved in the drafting of ERISA have stated that they cannot recall any mention of the subject when ERISA was being drafted.[23] The extent to which ERISA constraints were intended to restrict "social investments" is thus unclear. Senator Lowell Weicker (R-Connecticut) has, however, recently introduced legislation to relax the ERISA constraints on up to two percent of a fund's investment portfolio to encourage social investing.[24] The amount of the portfolio used for these purposes, the diversification of the investments, the net return test required, and the allowable effect on beneficiaries are issues which the courts are likely to ultimately decide. There have been very few court cases to date that focus directly on these controversial issues.

The dual legal issues of ownership and control of pension assets will also play a critical role in the overall debate, with the greatest importance centering on control. Who should control assets? What are the consequences of various approaches to control? Should the party that bears the ultimate cost have control?

The paper by James D. Hutchinson provides a comprehensive analysis of the legal environment. The questions and answers in Parts II and III carry the discussion further, and provide insights regarding the present legality of specific types of actions.

REALITIES OF MANAGING PENSION ASSETS FOR SOCIAL/POLITICAL PURPOSES

The realities of managing pension assets for social/political purposes are a matter of varying perspectives, reactions and concerns. Central questions repeatedly arise regarding who owns and controls the plan assets, who bears transaction costs and the risk of losses, and who is being helped or hurt.

Disparate Interests

When "social investment" advocates propose investment strategies, they implicitly assume that the participants in a pension plan are a united group. Are they? They assume that retired workers have the same interests and investment desires as newly hired workers; that minority workers, female workers, and white male workers have the same goals; that corporate management and union leadership can readily agree on an investment strategy; that the investment managers, the trustees, and the beneficiaries approach investment decision and risk uniformly. How many of these assumptions are correct?

The perspective of each of the major groups affected by the pension plan, it can be argued, is different. Trustees concerned about fiduciary liability have a different perspective than activists, local politicians or members of a state legislature. The same is true for investment managers, who often are judged on annual fund performance rather than on regional economic development or the rate of medical breakthroughs. Corporate executives attempting to counter lowcost foreign labor and skyrocketing energy costs by relocating their firms have a different perspective than union officials seeking to maintain area jobs and prevent plant closings. Yet all these people have an interest in their pension funds.

Does the existence of multiple perspectives among plan participants and administrators mean that agreements forming coherent investment goals are impossible? What is the importance of the Trust documents and how do they affect consequences? How does the level of plan funding effect the attitudes and interests of active workers versus retirees?

Control

Rifkin and Barber justify arguments for union or participant control of pension assets by arguing that corporations and large institutions currently have control of pension assets and are using them for their own benefit. They believe a revolutionary struggle for control is needed.

Discussion of the consequences of a dramatic change in who controls plan assets should be undertaken. Such an evaluation should assess the probable consequences of social or political

investment strategies being widely implemented. For example, if every state decided to invest its pension assets solely within its own borders, to what extent would the overall pattern of capital investment be affected? The President's Commission on Pension Policy is looking specifically at this set of issues.[25] And, early reports on findings by the Wisconsin Center include insights into this new "concentration" issue. Analysis of the control issue must include an assessment of who bears the risk of losses resulting from a charge such as that advocated by Barber and Rifkin.

FUTURE PROSPECTS

As pension fund assets reach 600 billion dollars and move towards a trillion, it is reasonable to assume that the debate over investment management will continue and intensify. One of the most sensitive issues currently affecting investment policy is the concept of social/political management of pension assets.

A comprehensive presentation of the issues should help professionals operating within the pension field, and regulators of the pension field, gain necessary understanding.

Realistic Expectations

Regardless of the potential growth of the management of pension assets for social/political purposes, one may conclude that effects thus far have been limited. Rifkin and Barber frequently refer in their book to the trillion dollars available in pension assets and seem to link the emergence of the Sunbelt and the decline of the Northeast and Midwest with a clearly identifiable flow of pension capital. It is inferred that capital is unavailable to the Greybelt states. This does not appear to be true. In fact, the New England Task Force on Capital and Labor Markets was forced to conclude:

> "availability of funds" is not the principal problem. Rather, factors such as high taxes, high transportation costs, cumbersome government structures and attitudes...these are the old troublesome problems that have plagued the New England economy for years.[26]

An Economic Development Administration (EDA) study also found the southward shift of New England business to be a myth. "Between 1969 and 1974, New England enjoyed a net gain of firms and jobs. Most, however, are whitecollar positions rather than positions suitable for bluecollar workers. 'The region is now being perceived as a less ideal location for production operations'."[27] If these assessments are true, some would question whether special objectives for pension investments can stop what may be a rational, efficient economic shift within a complex economy.

The same caution may be appropriate when arguing for the use of pension funds to solve other major social problems. Although pension funds have billions of dollars in assets, it must be remembered that during the 1960s the federal government spent billions of dollars to solve social problems that in many cases are still with us. What evidence now would suggest that a similar approach making use of pension dollars instead of tax dollars would bring success?

Issues

How social/political management has been practiced should be explored. Do implementation problems increase if the strategy changes from obtaining general societal benefits to obtaining specific benefits for smaller and smaller groups? Do problems of control, internal dissension, policy formation, and responsibility become increasingly important as investment strategies become more active and targeted towards specific groups and objectives? How do implications change under the primary approaches?

- Under the "all things being equal" rule, the decision-maker would choose the investment with the greatest positive social impact when faced with several investment opportunities offering equal economic net return. Is it true that there is little controversy concerning this approach?

- Is exclusion a common approach? By exclusion, we refer to the conscious technique of not investing in certain clearly defined investments. "You're talking about crossing out one firm from a universe that has a huge number of options."[28]

- Is inclusion more difficult? Is investing for reasons other than performance very risky and likely to be illegal? Examples of exclusion policies are to exclude nonunion, South African, redlining, nuclear, discriminatory, and polluting firms. Often, these investment guidelines are written directly into a pension plan by trustees or legislative bodies. Implicit in this approach is the assumption that given the range of investment opportunities available to an investment manager, he should be able to find an alternative investment with equal risk/return characteristics. Is this assumption true?

The discussion of social/political management might fruitfully include exploration of all the questions raised in this overview:

1. Can effective guidelines be drafted and how?

2. Can you obtain appropriate information to implement the guidelines, and how?

3. What are the consequences of a strategy to diversify or concentrate?

4. How do you measure risk, return and performance?

5. What do you do if an investment goes bad?

6. Who should evaluate and make the investment?

7. Who should oversee the investment?

8. How do you guard against fraud?

9. Should there be government regulations?

10. How will conflicts of interest be resolved?

Conclusion

It is difficult to conclude how important the issue of social/political management will become in the 1980s. It may effect the entire industry or only a small segment. It may become very important with public plans but not private. Or, a major shift could occur towards social/political investing if it became an active bargaining issue backed by broad-based social pressure, and possibly a change in the law. The many issues noted above have yet to be resolved. Of late, however, several corporations and money management organizations have moved to establish social objectives and separate funds to be managed with social objectives in mind. All of these, however, seem to be following a role of not reducing net return.

The ground rules for management and investment of the nation's largest capital pool are being questioned at the most fundamental level. Traditional economic market theory is being challenged by political investment activists. The social and the political are being lumped together, rather than being analyzed independently. The time for persons to study the issues, to articulate the real issues and distinctions, and to offer new understanding has arrived. This Policy Forum was designed to provide a catalyst for such educational action.

FOOTNOTES

1. Rifkin, Jeremy and Barber, Randy. The North Will Rise Again: Pension, Politics and Power in the 1980's. Beacon Press, Boston, Massachusetts, 1978, p. 168.

2. Pierce, Neil R. and Hagstrom, Jerry. "Unions, Frostbelt Seek More Control Over Pension Fund Investments." National Journal, January 27, 1979, pp. 145-57.

3. Rifkin and Barber, op. cit.

4. Opening Statement of Senator Metzenbaum Before the "Subcommittee on Citizens and Shareholders Rights and Remedies." November 21, 1979, p. 1.

5. Lyle, Rebeca and Bransford, Roger, "Feed the Hungry and Get Ten Percent." Meidinger Update, April, 1979.

6. Ibid, p. 6.

7. Parker, Richard and Taylor Tamsin. "Strategic Investments: An Alternative for Public Funds", Strategic Investment Advisors, 1979, p. 2.

8. Rifkin and Barber, op. cit., p. 122.

9. Curley, N. "Dollar Drain." Milwaukee Journal, February 2, 1975. "Rules and Regulations for Fiduciary Responsibility: CFR Title 29, Chapter F, Part 2550."

10. Greenwich Research Associates. Report on Large Corporate Pensions. 1978, p. 20, and Large Corporate Pension Funds 1979 Report to Participants.

11. Ray, George E. and Lamon, Harry V., Jr. "Fiduciary Responsibilities Under the New Pension Reform Act." Institute of Continuing Legal Education, University of Michigan. Ann Arbor, Michigan, 1976, p. XI.

12. Hutchinson, James D. "Living with ERISA's Fiduciary Standards," Textbook for Employee Benefit Trustees, Administrators and Advisors, Volume Eighteen, IFEBP, Milwaukee, Wisconsin, 1977.

13. U. S. Congress, House Pension Task Force Report on Public Employee Retirement System. Committee on Education and Labor Print, House of Representatives, 95th Congress, Second Session, pp. 188-190.

14. Lamon and Ray, op. cit., p. 10.

15. Lamon and Ray, op. cit.

16. Hutchinson, op. cit.

17. Rifkin and Barber, op. cit., pp. 184-193.

18. Bureau of National Affairs, Daily Labor Report, March 15, 1978, D4.

19. Ibid, p. D7.

20. House Pension Task Force Report, op. cit., p. 33.

21. Ibid, p. 34

22. Rifkin and Barber, op. cit., pp. 1-13.

23. Stern, Les. "Social Investing: A Volatile Issues Surfaces." Pension and Investments. October 23, 1978, p. 22.

24. O'Neil, Vincent, "Pensions, Politics and Prudent Man." Washington Report. September, 1978, p. 78.

25. Address by Thomas C. Woodruff, Executive Director, President's Commission on Pension Policy, Before Wisconsin Center for Public Policy, March 20, 1979. Bureau of National Affairs Pension and Report, March 26, 1979, p. 5.

26. Kaufman, Ann. "An Analysis of Current Issues in Pension Fund Investment Practices." Draft Report Northeast-Midwest Coalition, April, 1979, p. 7.

27. Ibid, p. 8.

28. Schotland, Roy. Pensions and Investments. October 23, 1978.

The Issue of National Policy

Lisle C. Carter, Jr.

THE ISSUE OF NATIONAL POLICY

I want to express my appreciation to the Employee Benefit Research Institute for inviting me to participate, and for holding this symposium.

Since I have to leave, I am particularly pleased that my colleague and fellow Commissioner, Paul Dean is here, who is more knowledgeable in these matters than I am. Of course, Tom Woodruff, our Executive Director, is also present.

As a member of the Commission, it is not appropriate for me today to draw any conclusions, or even to offer any prescriptive suggestions. The commission has just begun its own consideration of the issues that are being discussed. So, my task today is simply to suggest some of the questions that we, at the Commission, may be looking at, and I hope that that may contribute in some way, to your deliberations.

We are grappling with many of the same issues that you are. At our initial meeting, in fact, the Commission questioned its whole role in this area. I should say to you that there were commissioners who believed that we had a large enough mandate, through reform for the public and private pension system, and that we really did not need to get into this area. Nonetheless, the Commission decided to examine questions involving so-called social investment in pension funds.

My remarks are very topical for us on the Commission, because we begin our own consideration of these issues with a two-day symposium next week, on the 10th and 11th of December. We are not at all sure in what direction the Commission will go, and we have adopted what might be called a cafeteria approach. We are going to go down the line next week and look at a number of these issues, and then decide what our menu will be or whether we will eat at all.

Like any group in a similar situation, we are much like those examining an elephant in the dark. We are in dispute about the size of the problem, and also about its nature. It is not only difficult, but really impossible to say at this time how the Commission will come out.

Let me give you a list of the topics that we will be examining. The Commission will sponsor six panels examining the following questions: the role of non-management participants, active and retired, in establishing pension fund investment policies;

the legal environment for non-traditional investments; proxy voting issues; the portfolio impact of non-traditional investment criteria; targeting pension capital regional economic development needs; and, the use of pension assets to promote union interests. The Commission is mindful of the fact that considerable debate has taken place recently regarding alternative uses of pension funds, but the conceptual framework behind this issue is far from clear. The current debate seems to focus on public employee retirement plan and collectively bargained funds. But we see some evidence that are directly entering this, at least through the evidence of one large private fund, and that may be a harbinger for the future.

To look at these questions, there are a number of central issues, including who should have the responsibility for formulating the pension fund investment objectives. Should non-economic criteria be permitted in investment selection, if they increase the investment risk or diminish the return potential, and if so, who should bear the economic burden? Should collectively bargained pension funds be utilized as a capital source for regional economic development? Or, urban redevelopment? Is there a need for new financial instruments to balance supply and demand? Should a city or state's fiscal posture influence the investment policies of its pension funds? Should public employee pension funds be subject to more stringent fiduciary standards?

I would like to spend my time this morning outlining some important points associated with these questions. In doing so, I want to acknowledge that I am drawing heavily on the working paper prepared for the Commission by Judith Mares who is with us today and can answer any questions you may have.

The $500 billion pool of pension fund assets represents a major source of investment capital and confers tremendous economic power in terms of aggregate pension fund investments. Questions of the social responsibility of pension fund investments is inevitable. A threshold question is who has the right to make such decisions? Some assume that pension plan participants and beneficiaries and their legal representatives are the true owners of the fund reserves and are thereby entitled to a more dominant role in the investment management of the assets. However, defined benefit plans lack the direct relationship between participant account balances and the accompanying retirement benefits, which is maintained by defined contribution plans. Moreover, the interest of retired and not-yet-retired participants are not necessarily identical.

Mr. Hutchinson has done a good service in his development of the legal issues surrounding these questions. Because socially responsible investing has been attacked as being highly subjective, some have suggested strategic investments or alternative investments as less prejorative terms. Despite the terminology, current debate lacks a general concensus on what constitutes socially responsible investing. Unions are increasingly recognizing what has been called the incredible potential of pension funds as a tool to maximize union organizing objectives.

The fear of capital shortages, the decline in underwriting of small businesses, the decay of regional areas, and the need for urban revitalization caused some to turn to pension fund capital as a possible solution. All of these approaches seem to share a common thread. Pension funds depart from traditional practices by applying some degree of "non-economic" criteria to the investment process.

The term non-economic is somewhat imprecise because economic issues and measures may be very much at stake in some alternative applications. Perhaps non-financial is a more accurate term. In any event, my remarks address the most common strategies for application of non-traditional criteria: exclusion of an investment policy, proxy voting and social policy, the concentration of state and local investment as an investment policy of pension funds, and pro-union concentration of investments as a policy of collectively bargained pension funds.

You know, in government, often not to do something is, in itself, a policy. The same rule would seem to apply to the exclusionary method, when exclusionary methods are used in pension fund investments. The following are among the most frequently cited desirable targets for exclusion because some find their products or policies objectionable: investors in or lenders to the government of South Africa, or corporate businesses operating in that country; manufacturers of liquor and/or tobacco; EEO, OSHO and EPA violators; non-union companies.

If these various forms of exclusion are to be applied as investment strategies, the availability and reliability of data for categorizing companies must be reviewed. At present, only a very few firms pay any type of attention to social accounting for corporations. These include the Investors Responsibility Research Center, IRRC; Corporate Data Exchange, CDE; and the Counsel of Economic Priorities, CEP. In addition, it should be noted that to the extent that exclusionary motivators will be deemed to be based on a rationale other than to further the purpose of the trust, and thus possibly be improper, is an issue as yet not clearly tested.

Fiduciaries who wish to exclude certain companies from their investment universe and incorporate their intention in their trust document, of course, could be increasing their liability. On the other hand, at least in some situations, such as violations of OSHA, EEO, EPA, it may be very appropriate to argue that the companies involved have not internalized their costs adequately, and thus, are poor economic investments in the longer run.

The application of exclusionary criteria resulting in a reduction of the universe of available investments does not, in itself, incorporate a risk return sacrifice. It is possible, however, that if the universe becomes increasingly more restrictive as more portfolio managers enter this form of investment practice, the available portfolios may not meet prudence and fiduciary standards.

In a different strategy, a growing number of institutional investors are expressing their social preferences by voting on shareholder resolutions contained in company proxy statements. Issues over which shareholders have voiced concern range from the corporate covenants and management, to corporate social responsibility. Traditionally, institutional proxy voting policies have followed the Wall Street rule of voting in favor of corporate management decisions or divesting themselves of the shares. Since the early 1970's, the trend has been away from the Wall Street rule. A recent IRRC study detailed how the Bank of American trust involvement with Connecticut General Life Insurance Company, the State of Connecticut Retirement Fund, the Teacher's Insurance Annuity Association, Retirement Equity Fund, Harvard, and the Ford Foundation, have taken an active role in addressing socially oriented shareholder resolutions.

Each of the organizations has a committee designated to review the various proxy proposals. The concept of passing the proxy voting rights to the beneficial owners is frequently promoted as a means of insuring that the social interests of participants are accurately represented.

Another form of social investment involves policies suggesting that state and local pension funds should concentrate their investments within and to the benefit of their geographic regions. Applications of this approach calls for a different set of economic criteria in the investment process because varying levels of concentration are being proposed. Most call for retirement funds to be used to a greater extent in the development of the local economy. It is suggested in this investment process, that all things being equal a fund should choose the investment most positively impacting the local economy; or two, the additional benefit accruing to the participant beneficiaries should be sufficient to offset a potential loss of investment return.

One line of reasoning claims that promoting the economic health of the sponsor government is in the best interests of participant beneficiaries. Because of the low funding level of many public pension funds, the participants and beneficiaries are dependent upon the continued economic health of their employers, not only for their current job security and future earnings, but as a primary source of capital to pay benefits.

Others take this position further and argue that the gains accruing in terms of job preservation and future increased wages -- particularly when planned benefits are calculated on the basis of some final pay formula--stability of the local economy, and a continuing ability to provide services, should be considered as part of the evaluation of the total return on investment. Another argument claims the concentration of out-of-state investments in public pension funds support the decline of the regional economy. Traditional economics would suggest the previous situation is simply a matter of capital flowing to its most efficient use, and the public intervention would, therefore, create marketing

inefficiencies and harm the overall economy. Those who argue that capital market theories have diverted capital from certain regional areas state that effective public intervention is warranted and indeed necessary. Thus, the issue revolves around the adequacy of existing financial instruments, as prudent instruments for public plans, while simultaneously serving the capital needs of various geographic areas.

A number of public employee retirement funds already have emphasized investments with a perceived local economic impact. Current applications include direct loans to, and purchases of privately placed debts of local businesses, direct mortgages to participants, and concentration of government guaranteed pools within a designated census tract.

John Peterson, the director of the government financed research center of the Municipal Finance Officers Association suggested a host of questions which require further study. How does one determine which goals are desirable? For example, if the objective is to increase mortgage availability or lower the cost of housing, have the existing investment vehicles facilitated the desired results? How does one acquire adequate information? For example, how is a local company defined? How is that company's impact on the environment measured? Do legal barriers exist that suggest this is not in the exclusive benefit of the beneficiaries? Are pension funds the most efficient tool to achieve these goals, and what special processes would be needed for investments and what special guidelines would be needed for implementation? One might add to that, of course, if this is a desirable public policy, what legislation might be needed to make it effective and possible. ERISA-type legislation for public employee pension funds could have far-reaching effects on the concentration of local investments in a number of ways. For instance, the existence of ERISA-type fiduciary standards could raise serious questions for some about the prudence of pursuing socially-motivated regional investments. Furthermore, it has been suggested at times, there may be a problem of self-dealing, in a policy of concentration in favor of one class of participants and against another. For example, active workers as against retirees.

Some current literature suggest that union pension funds' assets are being used to undermine union jobs and the economic growth and stability of the region in which the union members live. As a result, Mr. Glover has indicated that his union plans to draft a preferred investment list of firms with good union management relations. Union officials argue that their best interest would be served by using the economic power of their pension funds in organizing drives, resolving labor disputes, and developing influence over corporations.

It has been suggested that this strategy may replace the use of strikes and boycotts, which are claimed to be less effective in a service oriented economy, as a means of influencing corporate management. Whether this approach raises consequential legal issues, of course, remains to be seen.

A somewhat different approach and more consistent with the regional investment concept, is that followed by the International Brotherhood of Electrical Workers; the IBEW invests 50 percent of its $750 million pension assets in FHA-VA guaranteed mortgages and single family homes which are completely built with union labor.

In summary, there is no shortage of proposed alternatives in response to issues posed on the ownership and control of pension funds and assets, and their relationship to the social issues which confront us. But there is also no shortage of questions raised by those alternatives.

Now, for some, this fact will argue that investment policies should stick to the traditional, financial criteria; for others, it will spur the search for realizable alternatives.

These questions and this conflict challenge the President's Commission on Pension Policy, and those of us who are here today.

Legal Standards Governing The Investment of Private Pension Capital

James D. Hutchinson
Charles G. Cole

Table of Contents

		Page
I.	INTRODUCTION	
	A. The Scope of this Analysis	29
	B. The Genesis of the Issue	31
	C. An Analytical Framework	33
	D. Defining "Social Investing"	35
II.	APPLICABLE LAW	
	A. Pre-ERISA Sources of Law	38
	B. ERISA	42
III.	ANALYSIS OF SOCIAL INVESTING UNDER ERISA	
	A. Structure of ERISA § 404(a)	46
	B. Social Investing under the Federal Prudence and Diversification Rules	48
	C. "Solely in the Interest of the Participants and Beneficiaries"	55
	D. The "Exclusive Purpose" Rule	68
	E. In Accordance With Plan Documents	71
	F. ERISA's Prohibited Transaction Rules	75
IV.	PRACTICAL ISSUES INVOLVING SOCIAL INVESTING	82
V.	SUMMARY	87

LEGAL STANDARDS GOVERNING THE INVESTMENT OF PRIVATE PENSION CAPITAL

I. INTRODUCTION

A. The Scope of this Analysis

It is not surprising that numerous interest groups are beginning to cast covetous eyes on the power to invest private pension capital. At present, the assets in private pension funds amount to more than $279 billion. When public retirement systems are included, the number exceeds $500 billion. Projections indicate that by 1985 the totals will surpass $1.3 trillion and will constitute nearly half of the external capital raised by U.S. corporations.1/

At the same time that this enormous pool of capital is being aggregated, our economy is being faced with difficult questions concerning the financial stability of some of its public and private institutions, such as the City of New York and the Chrysler Corporation. In each of these settings, retirement plan assets have been viewed as a remedy for the institution in distress. Other geographic areas or industries may look to employee benefit funds as a source of capital for future projects. These developments suggest that questions as to what social purposes should be accomplished through the use of public and private pension capital will continue to be important in the months and years that follow.

It is the purpose of this paper to address a narrow, yet important, aspect of the problem. The analysis that follows will attempt to review the legal standards applicable to the investment of pension trust capital, particularly in the private sector.2/ We will leave for another setting an

---

1/ Securities and Exchange Commission, Statistical Bulletin, Vol. 37, no. 5, at 8 (May 1978); Staff Report of the Subcommittee on Antitrust, Monopoly and Business Rights of the Senate Committee of the Judiciary, 96th Cong., 1st Sess., Beneficiary Participation in Private Pension Plans 1 (Comm. Print 1979).

2/ Public plans raise additional difficult issues, such as the varying standards of care applicable to fiduciaries of these plans, the possibility of conflicts of interest presented by public officials serving as fiduciaries, and constitutional protections for government employee pension interests. *See generally* Withers v. Teachers' Retirement System of the City of New York, 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979); General Accounting Office, *Funding of State*
(Footnote continued)

analysis of federal and state laws that affect the investment of assets held by university endowment funds, private foundations, and personal trusts.3/ Instead, our focus will be on the capital collected in private retirement plan trusts which are presently subject to a federal regulatory scheme contained primarily in ERISA,4/ the Internal Revenue Code,5/ and the Taft-Hartley Act.6/ One unifying factor that makes such capital pools more homogeneous than endowments and personal trusts is that they already are subject to a federal legal standard with an articulated social purpose -- the adequate financing of retirement benefits.7/

The analysis below concentrates on present legal standards, including those that have received little scrutiny in the social investing debate, in the hope that this will assist individuals analyzing the investment policies of pension plans to evaluate the potential issues that may arise in

---

2/ (Footnote continued)
and Local Government Pension Plans: A National Problem (HRD-79-66) (Aug. 30, 1979); Note, Public Employee Pensions in Times of Fiscal Distress, 90 Harv. L. Rev. 992 (1977).

3/ See, e.g., Uniform Management of Institutional Funds Act (approved in 1972 and since adopted by 25 states); see generally R. Ravikoff and M. Curzan, Social Responsibility in Investment Policy and the Prudent Man Rule (unpublished manuscript dated July 2, 1979).

4/ Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001 et seq. (1976) (hereinafter cited as ERISA).

5/ 26 U.S.C §§ 401 et seq., 501 et seq. (1976) (hereinafter Internal Revenue Code).

6/ 29 U.S.C. §§ 141-188 (1976).

7/ See ERISA § 2, 29 U.S.C. § 1001 (1976), quoted infra at note 111.

this setting. We will leave it to others to debate the social, political, and economic arguments concerning what the law *should* be in this area.8/

B. The Genesis of the Issue

Much of the current debate with respect to "social investment" of pension assets seems to suggest that this issue is of recent vintage. This is not surprising in light of the recent flurry of activity ranging from the widely quoted work of Messrs. Barber and Rifkin in *The North Will Rise Again: Pensions, Politics and Power in the 1980's*,9/ to legislation introduced in recent sessions of Congress,10/ and the pension

---

8/ The President's Commission on Pension Policy is presently studying this issue. *See* J. Mares, The Use of Pension Fund Capital, Its Social and Economic Implications 1 (September 1979) (Draft prepared for President's Commission on Pension Policy, hereinafter "Mares Draft"). The Congress has also explored this issue in recent hearings. *See* Staff Report, *supra* note 1. The Wisconsin Center for Public Policy has also recently obtained a study on the impact of local investing of plan assets. *See also* "Study Weighs 'Social' Investment Risk", *Pensions and Investments* 3 (Oct. 8, 1979) (study by State of Wisconsin).

9/ J. Rifkin and R. Barber, *The North Will Rise Again: Pensions, Politics and Power in the 1980's* (1978).

10/ *E.g.*, Revenue Act of 1978, P.L. 95-600, § 143, 92 Stat. 2763, 2796 (requiring pass through of voting rights in employer stock where defined contribution plan owns more than 10% of employer stock not publicly traded); S. 1745, 95th Cong., 2d Sess. (1978) (size of business alone will not disqualify investment under ERISA's prudence rule); S. 285, 95th Cong., 2d Sess. (1978) (plan may invest up to 2% of assets in small businesses without regard to prudent man rule); H.R. 12666, 95th Cong., 2d Sess. (1978) (modifying ERISA prudence rule to permit investment of up to 5% of plan assets in small businesses).

investment provisions in the 1979 Chrysler/U.A.W. contract settlement.11/ A recent study concerning the investments of major public and private plans has also stimulated discussion by identifying 99 "target companies" on the basis of social performance.12/

From a legal point of view, this aura of a newly burgeoning issue belies the more than a decade of debate on this problem in the Congress. As early as 1967, the AFL-CIO Convention adopted a "Policy Resolution on Proposals for Federal Legislation to Regulate Health, Welfare, Pension and Profit Sharing Plans" which favored the investment of pension funds in "socially useful projects."13/ This position was placed before Congress by Andrew J. Biemiller, the director of the legislative arm of the AFL-CIO, testifying on proposed federal fiduciary standards for private plans in

---

11/ The agreement is reported to have created an investment advisory board consisting of equal numbers of union and management members. Up to 10% of new contributions would be invested in residential mortgages in areas where UAW members live, and in nursing homes, nursery schools, federally qualified health maintenance organizations and other socially desirable projects. In addition, the union would have the right to recommend that pension trustees not invest in up to five companies that conduct business in South Africa. See BNA Pension Reporter, No. 263, at A-28-29 (Oct. 29, 1979). The Control Data Corporation also has recently instructed its investment managers to consider social criteria in investment decisions. "Control Data Instructs Fund Managers To Use 'Socially Responsible' Criteria," Pensions and Investments 1 (Aug. 13, 1979).

12/ Corporate Data Exchange, Inc., Pension Investments: A Social Audit (1979). For a vigorous critique of the criteria used to measure social performance in that study, see the accompanying paper of Professor Roy Schotland, Divergent Investment for Pension Funds (1979), infra. We do not here attempt to resolve this controversy over what conduct is "socially responsible" or how the degree of social responsibility practiced by a company should be measured.

13/ Hearings on H.R. 1045, H.R. 1046, and H.R. 16462 before the General Subcomm. on Labor of the House Comm. on Education and Labor, 91st Cong., 1st & 2d Sess. 102-04 (1969-1970).

December 1969.14/ In congressional hearings held in 1970, Walter Reuther of the U.A.W. made an eloquent plea for flexibility in the law so that trustees could invest in "high social priority projects."15/ Similarly, in hearings in 1973 Ralph Nader and Karen Ferguson of the Public Interest Research Group advanced a complex proposal which included a provision permitting investment of up to 10% of the assets of a pension fund in "special allowance investments" which were designed to reduce the housing, medical, and consumer expenses of retirees.16/ Indeed, several early versions of pension reform legislation authorized plan provisions permitting socially desirable investments without regard to prudence.17/

When we compare this activity to the final language of ERISA's fiduciary rules in the analysis that follows, it becomes apparent that the issue is not a new one. More importantly, the courts will not be writing on a clean slate when they undertake to resolve questions concerning the permissibility of socially desirable investments.18/ Therefore, it seems reasonable to conclude that the judiciary will act upon the premise that the legislature has considered this issue and provided an answer in ERISA's fiduciary standards.

C. An Analytical Framework

As set forth in more detail in the following analysis, ERISA establishes several key standards applicable to the investment of private retirement plan assets. First, fiduciaries are required to exercise the "care, skill, prudence, and diligence under the circumstances then prevailing" that would be exercised by a prudent fiduciary in the

---

14/ *Id.* at 109.

15/ *Id.* at 186, 194, 197.

16/ Hearings on H.R. 2 and H.R. 462, before the General Subcomm. on Labor of the House Comm. on Education and Labor, 93d Cong., 1st Sess. 260, 272, 292-93 (1973).

17/ *E.g.*, H.R. 16462, 91st Cong., 2nd Sess. (1969); S. 3580, 91st Cong., 2d Sess. (1969).

18/ For a more complete discussion of the legislative history of this aspect of ERISA, *see* text at notes 112-121.

conduct of a similar enterprise.19/ It is in this setting that considerations of risk, return, liquidity, and diversification come into play to ensure that the proposed investment makes sound financial sense for the plan. A second and distinct test is that the investment must be undertaken "solely in the interest of the participants and beneficiaries" of the plan.20/ This standard emanates from common law notions of loyalty which require a trustee to act in the furtherance of the interests of trust beneficiaries rather than himself or third parties.

ERISA also contains a third group of standards, which might be characterized as "structural" prohibitions because they will preclude certain types of transactions even though the resulting investment may be fair or prudent. Of singular importance are the statute's broad prophylactic rules against transactions involving a party-in-interest.21/ Transactions involving employer securities or employer real property are also specifically regulated.22/ Finally, every transaction must be executed "in accordance with the documents and instruments governing the plan."23/

Every proposal for social investing -- like any other investment -- must meet <u>each</u> of these standards. The mere fact that an investment <u>can</u> be defended as financially sound or "prudent" does not insulate it from challenge if it is being undertaken to serve the objectives of parties who are not plan participants or beneficiaries. Likewise, an investment that is undertaken to serve the direct interests of plan participants must still be justified as "prudent" in a financial sense. Finally, any investment must be checked against the strict prohibitions that prevent plans from dealing with related parties.

19/ ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B); 29 C.F.R. § 2550.404-1, promulgated at 44 Fed. Reg. 37225 (June 26, 1979). <u>See</u> text at notes 67-90.

20/ ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1); 44 Fed. Reg. 37222 n.2 (June 26, 1979). <u>See</u> text at notes 90-125.

21/ ERISA § 406, 29 U.S.C. § 1106. <u>See</u> text at notes 147-163.

22/ ERISA § 407, 29 U.S.C. § 1107.

23/ ERISA § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D). <u>See</u> text at notes 131-146.

D. Defining "Social Investing"

The issue of social investing has proven elusive of legal analysis in part because of its protean character. Depending upon the context, social investing may take different, sometimes philosophically inconsistent forms. A policy of social investment may be designed to provide incidental benefits to the participants by improving the community in which they live, or it may be designed to deal with some problem at a regional, national or even international level. A social investment program may involve a selfless sacrifice of the participants' interests in order to aid some other, less fortunate segment of society, or it may be part of a calculated strategy to enhance the political and economic strength of the participants. The techniques for implementing a policy of social investing may also vary widely -- from a policy of excluding future investments in particular companies to the affirmative selection of certain preferred investments to the divestiture of undesirable investments. In each of these situations, moreover, the relative weight given to economic and social factors may be different: social considerations may dictate investment policy, or they may be invoked only as a guide where all other characteristics are comparable.

Despite the wide diversity of practices often characterized as "social investing," we believe that almost all activity discussed in the context of "social investing" can be classified within one of three basic categories: (1) Totally Neutral Investment Policies, (2) Socially Sensitive Investment Policies, and (3) Socially Dictated Investment Policies.

"Totally Neutral Investment Policies" focus solely on the financial aspects of investment alternatives. In this regard, fiduciaries analyze the traditional investment considerations, such as the plan characteristics (design, funding, etc.), risk/return considerations, liquidity, and diversification.24/ Within this frame of reference, it may be that labor relations practices, compliance with environmental or safety standards, or other policies could affect

---

24/ 29 C.F.R. § 2550.404a-1, 44 Fed. Reg. 37225 (June 26, 1979).

the financial stability and profitability of a company whose securities are being analyzed. If the fiduciary making the financial analysis of the investment activity has a sound empirical basis for considering these factors, then their use is defensible on purely financial grounds.25/ No attempt is made to override basic financial investment considerations, nor to temper judgments on comparable alternatives by focusing on non-investment factors. The question of "social investing" never arises in this setting, and we need not confuse the legal analysis applicable to "social investing" by belaboring such practices.

"Socially Sensitive Investment Policies" include those investment policies and practices where the investing fiduciary analyzes traditional investment considerations such as plan characteristics, risk/return factors, liquidity and diversification. However, once this anlaysis is completed, the fiduciary then selects among financially comparable investment alternatives by considering other factors. As the analysis that follows indicates, so long as the fiduciary has not decided to sacrifice comparability of safety, return, diversification, or marketability in order to employ non-investment considerations, he has discharged his responsibility under the "prudence" standard.

There remains the question, however, whether the investment is being undertaken "solely in the interests" of plan participants and beneficiaries. It is at this point that certain "socially sensitive" investment policies that consider non-financial factors may pass legal muster, while others may not. In this regard, we believe that a review of the legislative history of ERISA, as well as recent legislative and judicial activity, suggests that certain non-financial considerations which are intended

---

25/ A recent Senate staff report concluded:

> In cases where social factors affect a company's profitability prospects, such criteria may be considered in the profitability analysis itself. Profitability may be adversely affected by such factors as instability of a company's labor relations and an unstable political situation in the country in which an investment is located or with which the company does business.

See Staff Report, supra note 1, at 1-2.

to serve the interests of plan participants, in their capacity as such, can be employed. On the other hand, considerations which cannot be related in some plausible fashion to the primary interests of plan participants, but instead serve the interests of the employer, union, or third parties, may well violate this standard or the more specific rules which prohibit dealings with parties related to the plan.

"Socially Dictated Investment Policies" are those investment practices and policies which either (1) permit the sacrifice of safety, return, diversification, or marketability, or (2) are undertaken to serve some objective which cannot clearly be related to the interests of plan participants and beneficiaries in their capacity as such. When a plan fiduciary undertakes to sacrifice traditional investment quality, he faces the substantial risk of violating the prudence standard. Likewise, if a fiduciary is acting to further his own interests or those of third parties, he will be in violation of the loyalty standard. Given the present state of the law governing the investment of plan assets, plan fiduciaries would be ill advised to direct or permit either kind of activity.

In sum, we believe that it is possible to categorize almost any particular investment policy or activity into one of these three areas. In the case of "Total Neutrality," the law does not restrain the investment activity of fiduciaries who choose to consider socially or politically charged factors when they are taken into account in order to arrive at sound financial conclusions. In the case of "Socially Sensitive" investment activity, there may well be considerable leeway for fiduciaries to factor in noneconomic issues so long as the financial soundness of the investment is not sacrificed and the direct interests of plan participants and beneficiaries are being served by the noneconomic considerations employed. Finally, whether or not "Socially Dictated" investment activity should be countenanced, the present state of the law suggests that plan fiduciaries would risk violation of their fiduciary obligations by sacrificing investment quality or employing plan assets primarily to serve the purposes of anyone but plan participants and beneficiaries.

II. APPLICABLE LAW

A. Pre-ERISA Sources of Law

Prior to the enactment of ERISA, there were three principal sources of law relevant to investment decisions by an employee benefit plan. First, all plans employing the trust device were governed by the fiduciary principles generally applicable to trusts under state law. Most familiar of these was the prudent man rule utilized in most states: in the absence of a contrary direction in the trust, the trustee is under a duty to "make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of income to be derived."26/ While an assurance of "reasonable" income is an objective under the common law,27/ most courts applying the common law rule look to the possibility of capital loss as the principal measure of the riskiness of an investment28/ and tend to focus on the prudence of the individual investment rather than the wisdom of the investment within the context of the entire portfolio.29/

26/ Restatement (Second) of Trusts § 227 (1959). See generally, Fleming, Prudent Investments: The Varying Standards of Prudence, 12 Real Prop. Prob. & Tr. J. 243 (1977); G.G. Bogert and G.T. Bogert, The Law of Trusts and Trustees § 612, at 410 (2d ed. 1960 and Supp. 1976) [hereinafter cited as Bogert]. A few states still limit the percentage of assets which may be invested under the prudent man rule and prescribe a "legal list" of permissible investments. Id. at 62 n.18 (Supp. 1976).

27/ Id. at Comment e.

28/ Note, Fiduciary Standards and the Prudent Man Rule Under the Employment [sic] Retirement Income Security Act of 1974, 88 Harv. L. Rev. 960, 966-67 (1975). Note, The Regulation of Risky Investments, 83 Harv. L. Rev. 603, 616-17 (1970).

29/ See, e.g., Withers v. Teachers' Retirement System of the City of New York, 447 F. Supp. 1248, 1254-55 (S.D.N.Y. 1978), aff'd, 595 F.2d 1210 (2d Cir. 1979); Bank of New York v. Spitzer, 35 N.Y.2d 512, 323 N.E.2d 700, 703 (1974); McKechnie v. Springfield, 311 Mass. 406, 414, 41 N.E.2d 557, 561 (1942); Restatement (Second) of Trusts § 213 (1959).

The common law also imposed upon the fiduciary of an employee benefit trust a duty of loyalty to the beneficiaries.30/ In order to prevent a conflict of interest, the fiduciary was forbidden from entering into transactions with the trust31/ or from competing with the trust *res*.32/ In addition to such specific proscriptions against self-dealing, the trustee was "enjoined to administer the trust solely in the interest of the beneficiary."33/ Under the common law, the terms of the trust could sometimes authorize the fiduciary to do what would otherwise be a breach of his duty of loyalty to the beneficiaries.34/

The common law received some reinforcement from certain provisions of the Internal Revenue Code. In order to qualify for tax exempt status under the Code,35/ the employer's plan must be maintained "for the exclusive benefit of his employees or their beneficiaries"36/ and the trust instrument must make it "impossible... for any part of the

---

30/ *See* III A. Scott, The Law of Trusts § 170 (3d ed. 1967).

31/ Restatement (Second) of Trusts § 170, Comments b, c, h (1959).

32/ *Id*. at Comment o.

33/ *Id*. at § 170. Although the common law duty of loyalty clearly precludes the trustee from taking any action for his own benefit, there is increasing support from commentators (but not the courts) for the view that an institutional trustee may follow an investment policy which benefits the community as a whole as well as the specific beneficiaries. III Scott, *supra* note 30, § 227.17 (1979 Supp.).

34/ II A. Scott, The Law of Trusts § 170.9 (3d ed. 1967). On grounds of public policy, some state statutes refuse to permit the terms of the trust to legalize more dangerous acts of disloyalty. G. Bogert, The Law of Trusts and Trustees § 543(U) at 377-78 (rev. 2d ed. 1978).

35/ Where a plan has qualified for such status, the employer may immediately deduct his contributions as ordinary and necessary business expenses, I.R.C. § 404(a), the plan need not ordinarily pay tax on its investment income, I.R.C. § 501(a), and the participant may defer payment of tax until the receipt of benefits. I.R.C. §§ 402(a)(1), 403(a)(1).

36/ I.R.C. § 401(a).

corpus or income to be...used for, or diverted to purposes other than for the exclusive benefit of his employees or their beneficiaries."37/

Although the exclusive benefit rule of the Internal Revenue Code applies to the investment of plan assets, historically, it has not been a stringent constraint.38/ The Internal Revenue Service and the courts have been understandably reluctant to enforce this provision by disqualifying plans and thereby depriving employees of the tax benefits to which they would otherwise be entitled.39/ The Internal Revenue Service has interpreted the exclusive benefit rule to permit some collateral benefit to other persons, as long as the investments have the primary purpose of benefiting employees or their beneficiaries.40/

37/ Id. at § 401(a)(2). A plan will be considered as not for the exclusive benefit of employees if it is a subterfuge for the distribution of profits to shareholders or if it discriminates in favor of officers, shareholders or highly compensated employees. I.R.C. § 401(a)(4); 26 C.F.R. § 1.401-1(b)(3). In certain circumstances, however, it may be possible for a plan to return to an employer excess contributions based on a mistake of fact, see ERISA § 403(c)(2)(A), 29 U.S.C. § 1103(c)(2)(A), or the residual assets of the plan after all obligations have been paid upon termination, ERISA § 403(c)(1), 29 U.S.C. § 1103(c)(1).

38/ The implementing regulations authorize the purchase of any investment permitted by the trust agreement to the extent allowed by local law. 26 C.F.R. § 1.401-1(b)(5)(i).

39/ S. Rep. No. 93-383, 93d Cong. 1st Sess. 3-4, 18 (1973); Herbert, Investment Regulation and Conflicts of Interest in Employer-Managed Pension Plans, 17 Boston College Ind. & Comm. L. Rev. 127, 140-41 (1976); Time Oil Co. v. Commissioner, 258 F.2d 237, 238 (9th Cir. 1958).

40/ E.g., Revenue Ruling 69-494, 1969-2 C.B. 88. The Service has taken the position that other parties -- including the employer -- may benefit from plan investments as long as four investment requisites are met:

> These requisites are: (1) the cost must not exceed fair market value at time of purchase; (2) a fair return commensurate

(Footnote continued)

The courts have agreed that the rule is not contravened where an incidental benefit inures to a third party.41/

A third, pre-ERISA source of legal control on the operations of employee benefit plans was § 302(c)(5) of the Taft-Hartley Act,42/ which applies only to plans established jointly by a union and one or more employers. This provision permits employer contributions to the trust fund only if the trust meets certain conditions designed to prevent diversion of the funds by union officers to themselves or to the union.43/ The Act also requires that the trust fund be established "for the sole and exclusive benefit of the employees of such employer, and their families and dependents."44/

40/ (Footnote continued)

> with the prevailing rate must be provided; (3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and (4) the safeguards and diversity that a prudent investor would adhere to must be present.

Id. Although this administrative interpretation of the statute is entitled to some deference, see Central Motor Co. v. United States, 583 F.2d 470, 490 (10th Cir. 1978), it has never been explicitly sustained by the courts. See Shelby U.S. Distributors, Inc., 71 T.C. No. 77 (Feb. 20, 1979).

41/ Shelby U.S. Distributors, Inc., 71 T.C. 874 (1979); Feroleto Steel Co. v. Commissioner, 69 T.C. 97, 113 (1977).

42/ 29 U.S.C. § 186(c)(5)(1976).

43/ For example, there must be a written agreement detailing the basis on which payments are to be made, and the fund must be jointly administered by equal numbers of employer and union representatives. § 302(c)(5)(B), 29 U.S.C. § 186(c)(5)(B). The Act permits the addition of mutually agreeable neutral persons. Id.

44/ § 302(c)(5)(A), 29 U.S.C. § 186(c)(5)(A).

Most federal courts have interpreted § 302 as governing the structure of covered plans and not as granting jurisdiction to the federal courts to adjudicate individual violations of fiduciary standards.45/ Nevertheless, the courts have invoked the "sole and exclusive benefit" provision as a jurisdictional basis for invalidating those general rules or practices of trust administration which appeared designed to benefit persons other than the employees.46/ For example, allegations that a break-in-service provision of a pension plan was intended primarily to benefit the union have been held to state a claim under § 302(c)(5).47/ Although § 302(c)(5) remains a viable jurisdictional basis for challenging certain practices of jointly-administered trusts,48/ its utility has been overshadowed by the more pervasive provisions of ERISA.49/

B. ERISA

Congress passed the Employee Retirement Income Security Act of 1974 (ERISA) after nearly a decade spent

---

45/ E.g., Haley v. Palatnik, 509 F.2d 1038,1040-41 (2d Cir. 1975); Snider v. All State Adm'r, Inc., 481 F.2d 387, 390 (5th Cir. 1973), cert. denied, 415 U.S. 957 (1974); Bowers v. Ulpiano Casal, Inc., 393 F.2d 421, 424-26 (1st Cir. 1968).

46/ Souza v. Scalone, 64 F.R.D. 654 (N.D. Cal. 1974), vacated on other grounds, 563 F.2d 385 (9th Cir. 1977); Lugo v. Employees Retirement Fund of the Illumination Products Industry, 366 F. Supp. 99 (E.D.N.Y. 1973); Insley v. Joyce, 330 F. Supp. 1228 (N.D. Ill. 1971).

47/ E.g., Insley v. Joyce, 330 F. Supp. 1228 (N.D. Ill. 1971). Even under this provision, however, an indirect or incidental benefit to the union or the employer would probably not be prohibited by the statute. See, Culinary Workers and Bartenders v. Gateway Cafe, 91 Wash 2d 353, 588 P.2d 1334 (1979); Lugo v. Employees Retirement Fund of the Illumination Products Industry, 388 F. Supp. 997, 1001 (E.D. N.Y. 1975) aff'd 529 F.2d 25, cert. denied 429 U.S. 826.

48/ ERISA § 514(d), 29 U.S.C. § 1144(d) (saving all federal laws from preemption).

49/ Cutaiar v. Marshall, No. 78-1380 (3d Cir. Jan. 12, 1979), BNA Pension Reporter No. 223, at D-9 (Jan. 22, 1979).

reviewing the existing legal framework for the regulation of employee benefit plans. By its terms, ERISA preempts all state laws "insofar as they may now or hereafter relate to any employee benefit plan" covered by the statute.50/ This provision, which took effect January 1, 1975, precludes the application of state fiduciary principles to investment decisions made after that date.51/ Although the requirements of the Internal Revenue Code applicable to tax-qualified employee benefit plans remain in effect, the Conference Report to ERISA indicates that a fiduciary who meets the standards for investment contained in ERISA will be deemed to be in compliance with those aspects of the exclusive benefit requirements of the Internal Revenue Code.52/ Similarly, it would appear that satisfaction of the more specific standards of ERISA would suffice in demonstrating compliance with the "exclusive benefit of the employees" rule of the Taft Hartley Act.53/

Thus, questions as to whether various forms of social investing are permissible for private sector employee benefit plans must be determined by reference to the fiduciary standards of ERISA.54/ Decisions under prior

---

50/ ERISA § 514(a), 29 U.S.C. § 1144(a).

51/ Marshall v. Chase Manhattan Bank, 558 F.2d 680 (2d Cir. 1977). For a more comprehensive discussion of the preemptive effect of ERISA, *see generally* Hutchinson & Ifshin, *Federal Preemption of State Law Under the Employee Retirement Income Security Act of 1974*, 46 U. Chi. L. Rev. 23 (1978); Turza, *Preemption of State Laws Under the Employee Retirement Income Security Act of 1974*, 28 Cath.U.L.Rev. 163 (1979).

52/ H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 302 (1974) (hereinafter "Conference Report").

53/ Cutaiar v. Marshall, No. 78-1380 (3d Cir. January 12, 1979), BNA Pension Reporter, No. 223, at D-9 (Jan. 22, 1979).

54/ ERISA does not cover plans maintained by state or local governments. *See* ERISA §§ 3(32) and 4(b)(1), 29 U.S.C. §§ 1002(32) and 1003(b)(1). Feinstein v. Lewis, 79 Civ. 2204 (S.D.N.Y. Oct. 12, 1979), BNA Pension Reporter, No. 263, at D-9 (Oct. 29, 1979). In 1978, Representatives Dent and Erlenborn, the chairman and ranking minority member of the House Labor Standards Subcommittee, introduced a proposed Public Employee Retirement Income Security Act (PERISA), H.R. 14138, 95th Cong. 2d Sess. This bill would have subjected (Footnote continued)

law remain relevant, however, because in fashioning ERISA, Congress was acutely aware of the pre-existing legal framework, and drew language and principles from the earlier bodies of law. Points of similarity with traditional fiduciary standards -- and points of difference -- can provide guidance as to the proper interpretation of the statute.

In the hearings that preceded the passage of ERISA, Congress examined the investment practices of employee benefit plans under the existing legal framework. The hearings exposed such abuses as excessive investments in employer stock, absence of diversification, and use of plan assets for the benefit of plan fiduciaries.55/ The Congressional committees found that the common law emphasis on the intent of the grantor, which permitted deviations from sound investment practices, was inappropriate for employee benefit plans.56/ The Committee Reports also pointed out the inadequacies of the existing legal procedures as means of controlling abuses and the need for a uniform fiduciary standard in the interstate context.57/

As a result of these congressional perceptions, ERISA established new federal fiduciary standards and a system for imposing and enforcing those standards. Under the scheme of the Act, every plan must provide for one or more "named fiduciaries" having authority to control and

---

54/ (Footnote continued)
fiduciaries for public plans to the same standards of fiduciary responsibility as apply to private plans under ERISA § 404(a)(1), as well as adding certain prohibited transactions. See BNA Pension Reporter, No. 207, at A-15, R-19 (Sept. 25, 1978). While this legislation was not enacted by the 95th Congress, there is continuing pressure to enact legislation protecting the interests of participants in public plans.

55/ See Hearings, supra note 13, at 470-72 (Appendix to Testimony of George Shultz).

56/ H.R. Rep. No. 93-533, 93d Cong., 1st Sess. 12 (1973); S. Rep. No. 93-127, 93d Cong., 1st Sess. 29 (1973)

57/ Id.

manage the plan.58/ Trustees named in the trust instrument or appointed by a named fiduciary have exclusive authority and discretion over the management of plan assets,59/ unless the plan expressly provides that the trustee will be subject to the direction of a named fiduciary60/ or that investment authority will be delegated to an investment manager.61/

All persons exercising discretionary authority or control with respect to the management of the plan or its assets come under the Act's broad definition of "fiduciary."62/ The definition specifically embraces the plan's trustee, any

---

58/ ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1).

59/ ERISA § 403(a), 29 U.S.C. § 1103(a).

60/ ERISA § 403(a)(1), 29 U.S.C. § 1103(a)(1).

61/ ERISA §§ 402(c)(3) and 403(a)(2), 29 U.S.C. §§ 1102(c)(3) and 1103(a)(2). See also ERISA § 3(38), 29 U.S.C. § 1002(38) (definition of "investment manager").

62/ ERISA 3(21)(A), 29 U.S.C. § 1002(21)(A), provides in relevant part:

> a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

investment managers to whom investment authority may have been delegated, and persons supplying investment advice for compensation.63/ Thus, any person who directs the investment of plan assets -- whether for social or financial purposes -- is a fiduciary for purposes of the statute.

A fiduciary is subject to both the general fiduciary standards contained in ERISA § 404 64/ and the specific "prohibited transaction" provisions of ERISA § 406. 65/ In addition, a fiduciary may be held liable for a knowing failure to prevent or remedy a breach of trust by a co-fiduciary.66/ Thus, although a trust may delegate responsibility for investment decisions to a qualified investment manager, the trustee who learns of a violation of the statute's fiduciary standards on the part of the manager may be held liable for failure to take appropriate action. In sum, ERISA casts a broad net over all who have some responsibility for the management of the plan and may entangle them -- like it or not -- in the issue of social investing.

III. ANALYSIS OF SOCIAL INVESTING UNDER ERISA

A. Structure of ERISA § 404(a)

The central provision regulating the investment activities of fiduciaries under ERISA is § 404(a) of the statute, which provides:

63/ Under the applicable regulations, a recommendation to purchase or sell a security is investment advice if the individual rendering it has discretion to make investment decisions or if he renders advice specialized for the plan with the understanding that his advice will be relied upon as a primary source of guidance in making investment decisions. 26 C.F.R. § 54.9975-9(c)(1)(1978); 29 C.F.R. § 2510.3-21(c)(1)(1978).

64/ 29 U.S.C. § 1104.

65/ 29 U.S.C. § 1106. The limitations imposed by this section are more fully discussed *infra* at text at notes 147-164.

66/ ERISA § 405, 29 U.S.C. § 1105; 29 C.F.R. § 2509.75-5, FR-10 (1979).

Sec. 404(a)(1) Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and --

(A) for the exclusive purpose of:
(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title.

Two features of this provision should be noted at the outset.

First, its standards apply to all of the duties for which a fiduciary is responsible under the plan. Thus, the requirement of prudence constrains not only the selection of investments but also the selection of an investment manager or advisor, the formulation of investment guidelines, and the ongoing monitoring of the plan's investment activity. These standards also apply to decisions which do not concern investments, such as the operating policies of the plan.

Indeed, a fiduciary can be bound by the requirements of § 404(a)(1) even in recommending, designing or implementing amendments to the structure of the plan.67/

Second, fiduciary standards established by this provision are in the conjunctive; each must be satisfied by a proposed course of action. Thus, an investment that is prudent within the meaning of § 404(a)(1)(B) but that violates the "solely in the interest of the participants and beneficiaries" standard of § 404(a)(1) does not comply with the statute. Similarly, activity that is prudent and solely in the interest of the participants and beneficiaries may be impermissible if it is not exclusively for the purpose of providing benefits and defraying the reasonable expenses of the plan as required by § 404(a)(1)(A) or has been undertaken in violation of plan documents, § 404(a)(1)(D). Because the fiduciary standards imposed by this provision are distinct, we examine them separately below.

B. Social Investing under the Federal Prudence and Diversification Rules

Much of the current debate over the propriety of social investing has focused on whether the prudence rule permits such investments. The federal prudence rule contained in ERISA § 404(a)(1)(B) provides no direct answer to this question. Whether a particular social investment is permissible under this section depends not only on the nature of the investment, but also on the needs of the plan and the characteristics of the remainder of the plan's portfolio.

Although ERISA § 404(a)(1)(B) is based on the prevailing common law rule, the federal rule for covered

---

67/ *See* Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978); Winpisinger v. Aurora Corp., 456 F. Supp. 559 (N.D. Ohio 1978).

employee benefit plans differs in important respects.68/ Under the federal provision, the conduct of a fiduciary must be compared with that of other fiduciaries "acting in a like capacity, and familiar with such matters...in the conduct of an enterprise of like character and with like aims."69/ The legislative history makes clear that the purpose of this language was to fashion a flexible standard of prudence which would take into account the special purposes of employee benefit plans and the vast diversity among them.70/ The Labor Department has recognized, for example, that the manager of a plan with assets of $50,000 need not employ the same investment management techniques as would a fiduciary of a plan with assets of $50,000,000.71/

68/ The preamble to the Department of Labor regulation explicating this subsection states that "[t]he 'prudence' rule in the Act sets forth a standard built upon, but that should and does depart from, traditional trust law in certain respects." 44 Fed. Reg. 37222 (1979). Accord, Marshall v. Teamsters Local 282 Pension Trust Fund, 458 F. Supp. 986 (E.D.N.Y. 1978).

69/ ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

70/ In hearings in 1970, Secretary of Labor George Shultz characterized similar language in H.R. 16462 as providing a standard with "a built in flexibility...which recognizes the vast diversity and other characteristics of private pension and welfare plans." See Hearings, supra note 13, at 477. See generally Report, ERISA and the Investment Management and Brokerage Industries: Five Years Later, 35 Bus. Law. 189, 238 n. 35 (1979). The American Bankers Association favored this language because it would give the trustees of employee benefit funds "sufficient latitude to invest the funds to the best advantage in current and future markets." Hearings, supra note 13, at 792.

71/ 44 Fed. Reg. 37224 (1979). On the other hand, the sliding scale used by the Labor Department means that a plan with sufficient funds to defray the expense of professional investment advice must be able to justify the prudence of its investments -- including its social investments -- with relatively sophisticated financial analysis.

The federal regulations also recognize the need to take into consideration the funding objectives and cash flow requirements of the plan in evaluating the rate of return and liquidity of a proposed investment.72/ In general, an investment program must be designed with due regard for such varying plan characteristics as the nature and size of the plan, its tolerance for risk, funding status, liquidity needs, and contribution rates.73/

Similarly, the prudence of a proposed form of social investing cannot be evaluated in the abstract. The particular investment must be judged in light of the complete factual setting, including the plan's needs and characteristics. The trustee must consider whether "under the circumstances then prevailing" the investment might be chosen by a prudent man managing a plan "of like character and with like aims."

For example, the basic structure of the plan would be one relevant consideration in determining whether a social investment were permissible. In a defined benefit plan, the sponsoring employer or employers are responsible for making contributions adequate to provide a specified level of benefits to the participants.74/ The sponsor bears the primary risk of capital loss or inadequate income to cover the plan's current obligations. In this situation, it would be less likely that a participant would challenge the conduct of a trustee or investment manager who, with the concurrence of the sponsors, followed a socially sensitive investment policy. Similarly, a socially dictated policy, even though resulting in a technical violation of the Act, would be less likely to provoke a challenge, as long as the employer

---

72/ 29 C.F.R. § 2550.404a-1(b)(2), promulgated at 44 Fed. Reg. 37225 (1979).

73/ For a general discussion of the federal prudence standard, see Hutchinson, The Federal Prudent Man Rule Under ERISA, 22 Vil. L. Rev. 15, 42 (1976); Klevan, Fiduciary Responsibility Under ERISA's Prudent Man Rule: What are the Guideposts? 44 J. Tax. 152 (1976); Note, Fiduciary Standards and the Prudent Man Rule Under the Employment [sic] Retirement Income Security Act of 1974, 88 Harv. L. Rev. 960 (1975); Report, ERISA and the Investment Management and Brokerage Industries: Five Years Later, 35 Bus. Law. 189, 237-42 (1979).

74/ See ERISA § 3(35), 29 U.S.C. 1002(35); International Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 554 n.3 (1979).

maintained the specified level of benefits. In a defined contribution plan, on the other hand, the funding obligation of the employer is limited to the amount specified in the plan documents, and the employees bear very direct investment risks. A socially dictated investment policy would not only be much harder to justify in this context, but also would more likely provoke litigation as participant benefits were lost.

The nature of the plan is not the sole or conclusive factor to be considered. Even in a defined benefit plan, there is a risk that the employer will be unable to meet its funding obligations. If the plan has a large unfunded liability, and the employer is not in good financial health, it would be less prudent to invest in socially desirable projects that carry a high risk of loss. On the other hand, socially sensitive investing by a defined contribution plan may not be imprudent where a thorough analysis of the plan's portfolio shows that the risk and return associated with the investment complement the remainder of the plan's portfolio in meeting the plan's investment objectives.

In this regard, a second important change wrought by ERISA in the prudent man rule was a shift in approach from evaluation of an investment without regard to other investments toward evaluation of the investment in the context of the entire portfolio. Under the common law, the trustee could not defend his actions by showing that losses with respect to a particular investment were offset by gains on other investments or investment income.75/ The common law approach arose in part from the need to resolve a basic conflict between the interests of income beneficiaries and remaindermen, a conflict presented differently, if at all, in the context of employee benefit plans.76/

Recognizing that the common law of trusts must be interpreted "bearing in mind the special nature and purpose of employee benefit plans,"77/ the Department of Labor has issued regulations which authorize a trustee to analyze the

---

75/ See note 29 supra.

76/ See 43 Fed. Reg. 17481 (1978); Note, supra note 73, at 967.

77/ Conference Report at 302.

prudence of an investment by taking into account the role it plays within the overall plan portfolio.78/ The preamble explains that the relative riskiness of an investment, standing alone, does not make the investment *per se* prudent or *per se* imprudent.79/ The regulations provide a safe harbor to the fiduciary who gives "appropriate consideration" to the relevant facts and circumstances, including the role that an investment or investment course of action plays in the plan's portfolio.80/ The fiduciary should consider both the possibility of capital gain or loss and the probable income associated with the investment.81/ He must determine whether the investment or investment course of action is reasonably designed, as part of the portfolio, to further the purposes of the plan.82/ The fiduciary is specifically directed to give attention to such factors as the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the funding objectives of the plan.83/

This flexible interpretation of the prudent man rule permits a larger universe of investments under the prudence rule of ERISA than under the common law.84/ For example, the preamble to the Labor Department regulations points out that investment in securities issued by a small or new company, which may be riskier than those of a "blue chip" company, may be entirely proper under the Act.85/ The

---

78/ 29 C.F.R. § 2550.404a-1, 44 Fed. Reg. 37221 (1979).

79/ 44 Fed. Reg. 37224 (1979).

80/ 29 C.F.R. § 2550.404a-1(b)(1).

81/ 29 C.F.R. § 2550.404a-1(b)(2).

82/ *Id.*

83/ *Id.*

84/ 44 Fed. Reg. 37225 (1979).

85/ *Id.* at 37222.

Department also has recognized the possibility that investments that do not produce current income -- such as precious metal or objects of art, particular types of real estate investments, or certain stock option strategies -- might play a legitimate role in a portfolio.86/ In appropriate circumstances other "nontraditional" investments, such as certain types of venture capital or commodity futures investments, also might be permissible.

While the regulations do not refer in any way to the possibility of social investing, the "whole portfolio" approach adopted by the regulations may make it somewhat easier to defend the prudence of an investment which has been undertaken in consideration of non-financial factors. For example, even though an investment in a pool of local mortgages may yield a lower rate of return than a projected return on corporate equities, the mortgage investment may be designed to help stabilize performance and provide diversification within a portfolio already holding large concentrations of equity securities. Investment in a new local business as part of an effort to revitalize a downtown area may not be imprudent depending upon the relative size of the plan's portfolio, the relative riskiness of the other investments, the liquidity and income needs of the plan, and a determination that the local investment will play an appropriate part in meeting the plan's investment objectives.

It should be noted, however, that the regulation is not intended to create pockets of unrestricted "mad money" which can be invested in any vehicle striking the fancy of the fiduciary with investment control. A fiduciary cannot ignore his obligation to evaluate a particular investment as consistent with plan characteristics and objectives merely because a favorable return on the total portfolio is assured by high returns on other investments the plan has made. The preamble to the Labor Department regulations emphasizes that "a particular plan investment cannot be deemed prudent solely by reason of the aggregate risk/return characteristics of the plan's portfolio" and that "appropriate consideration of an investment to further the purposes of the plan must include consideration of the characteristics of the investment itself."87/

86/ *Id.* at 37224-25.

87/ *Id.* at 37224.

Analysis of the role played by an investment within the plan's portfolio necessarily includes consideration of whether the plan is adequately diversified. In order to give special emphasis to this factor, ERISA § 404(a)(1)(C) specifically states that a fiduciary must discharge his responsibility to the participants and beneficiaries

> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. . . .

Although there is no fixed percentage limit on the degree of investment concentration, the Conference Report lists a number of relevant facts and circumstances:

> (1) the purposes of the plan; (2) the amount of plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares or stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; (7) the dates of maturity.88/

The statute's policy of diversification might well make it easier to invest a small percentage of the plan's assets in socially desirable investments whose characteristics differ from the other investments in the portfolio, but the federal rule of diversification places an important limit on the breadth of any specific program of social investing. A fiduciary could not, for example, decide to devote all or even a substantial part of the plan assets to local investments. The Conference Report specifically notes that "a fiduciary should not invest the whole or an unduly large proportion of the trust property in . . . various types of securities depending upon . . . conditions in one locality, since the effect is to increase the risk of large losses."89/ Similarly, "[i]f he is investing in mortgages on real property he should not invest a disproportionate amount of the trust in mortgages in a particular district or on a particular class of property so that a decline in property values in that

---

88/ Conference Report at 304.

89/ *Id.*

district or of that class might cause a large loss."90/ Thus, even where a socially desirable investment is financially sound in terms of risk, return, and liquidity, the fiduciary must resist the temptation to concentrate the resources of the plan in that particular type of investment.

In summary, the federal prudence and diversification rules neither absolutely preclude nor specifically authorize the selection of investments that have been affected by non-financial considerations. They require that the fiduciary undertake an analysis of the suitability of the individual investment, comparing the risks and return associated with the investment to the needs of the plan and the characteristics of the remainder of the plan's portfolio, and the availability of alternative investments that could serve the plan's need to an equal or greater degree.

This analysis may well produce a range of investment alternatives that are truly comparable in terms of serving the plans' articulated investment objectives, thereby permitting some latitude in considering non-financial characteristics of the investment alternatives. However, even if the plan's investment objectives have not been compromised to produce collateral "social" results, the fiduciary still must consider the other standards which govern his conduct.

C. "Solely in the Interest of the Participants and Beneficiaries"

An investment program that meets the threshold financial requirements of the prudence rule contained in § 404(a)(1)(B) also must be undertaken "solely in the interest of the participants and beneficiaries" as required by ERISA § 404(a)(1).91/ The "solely in the interest" test

---

90/ *Id.*

91/ The preamble to the final prudence regulation explains that a reference to the "solely in the interest" language of § 404(a)(1) was deleted from the final regulation "to avoid suggesting that satisfaction of the 'prudence' rule with respect to an investment or investment course of action necessarily implies satisfaction of that additional requirement." 44 Fed. Reg. 37222 (1979). This delineation between the separate and distinct concepts of prudence and loyalty is embedded in the structure of the Act and the common law.

is an extension of the common law principle which imposed on a trustee an undivided duty of loyalty to the beneficiaries in the administration of a trust. As with the common law duty of loyalty, this obligation applies to all responsibilities of the fiduciary and is of "fundamental" importance.92/ It stands at the head of ERISA's section on fiduciary responsibility and is complemented by the specific admonitions in § 404 and the detailed proscriptions against self-dealing contained in ERISA §§ 406 and 407. Because of the importance of this principle to the scheme of the statute, and because this language directly addresses the problem of the purpose of plan investments, a proposed social investment must be subjected to close scrutiny under this provision.

While the guiding principle for this provision springs from the common law, its language appears to have been drawn from the Internal Revenue Code and the Taft Hartley Act. The case law developed under these statutes suggests that, despite the forbidding rigidity of terms such as "sole" and "exclusive," an investment that results in an incidental benefit to a third party is not necessarily inconsistent with the statute.93/ The crucial question is whether the primary purpose of the investment is to benefit the participants or beneficiaries of the trust.94/ Purpose is not to be evaluated, however, simply upon the basis of declarations of subjective intent supplied by the fiduciary. A court might well decide to draw an inference concerning the primary intent of the fiduciary from the practical effects of his actions.95/ Thus, an investment that provides a substantial economic benefit to a party in interest is vulnerable to challenge under this provision, regardless of the subjective intent of the fiduciary.

92/ 2 Scott on Trusts 1297 (3d ed. 1967).

93/ *See* text at notes 40-41 *supra*.

94/ Revenue Ruling 69-494, 1968-2 C.B. 88.

95/ Feroleto Steel Co. v. Commissioner, 69 T.C. 97, 108 (1977).

At a minimum, then, the "solely in the interest" test of § 404(a)(1) would proscribe any form of social investing which has as its primary purpose to benefit any party responsible for the management or administration of the trust. Thus, a locally based employer whose plan of social investing consists of a program of local investments designed to strengthen the financial viability of his customers or commercial lenders is not acting "solely in the interest of the participants and beneficiaries." Similarly, it has been held to be a violation of ERISA's duty of loyalty for a plan to purchase employer securities or employer debt obligations without considering the paramount interests of the participants and beneficiaries.96/ While such programs might provide incidental benefits to the participants both as employees and as local residents,97/ the employer will find it difficult to show that its interests were not given paramount consideration.

Similarly, this provision would proscribe any social investment whose primary purpose is to benefit the employees' union, even though the employees may benefit indirectly as well. This application of the principle of loyalty is illustrated in a case decided prior to the enactment of ERISA under the common law, Blankenship v. Boyle,98/ which is probably best remembered for its holding that the United Mine Workers Welfare and Retirement Fund, jointly administered by the UMW and the coal industry, had imprudently maintained excessive funds in non-interest-bearing accounts in a bank owned by the Union. The plaintiffs also challenged investments by the trust fund in certain public utility companies on the theory that these investments had been acquired in order to force the utilities

---

96/ Eaves v. Penn, 426 F. Supp. 830 (W.D. Okla. 1976), aff'd in part and remanded, 587 F.2d 453 (10th Cir. 1978); Freund v. Marshall & Ilsley Bank, 76-C-543 (W.D.Wisc. Sept. 24, 1979), BNA Pension Reporter, No. 262, at D-1 (Oct. 22, 1979).

97/ Cf. Exemption from Prohibitions Respecting a Transaction Involving Stryco Manufacturing Co. Pension Trust, 41 Fed. Reg. 20455, 48200 (1976) (extension of loan for rebuilding of employer's plant destroyed by fire requires an exemption from prohibited transaction rules).

98/ 329 F. Supp. 1089 (D.D.C. 1971).

to purchase coal produced by unionized companies. The evidence showed that the Fund's acquisitions of utility stock had been coordinated with those of the Union and that the Union had exercised the Fund's proxies. The court concluded that "[t]he intimate relationship between the Union's financial and organizing activities and the utility investment activities of the trustees demonstrates that the Fund was acting primarily for the collateral benefit of the Union and the signatory operators in making the most of its utility stock acquisitions."99/ The court therefore found a "clear case of self-dealing" on the part of the Union and management representatives and held the Union liable as well for conspiring to benefit from the breach of trust.

The holding in Blankenship v. Boyle is remarkable for two reasons. First, although the investments had declined in value, the court's holding did not rest on the prudent man rule, but only upon a breach of the duty of loyalty. Second, the court recognized that, "[i]n the longer view of matters, the Union's strength protects the interests of the beneficiaries, past and prospective."100/ Indeed, the Court specifically noted that "while the beneficiaries have suffered as a result of the Fund's loss of investment income, they have benefited to some extent from the Union's activities over the past twenty years."101/ Thus, the court found a breach of the duty of loyalty to the participants and beneficiaries even though it recognized that, in an indirect sense, workers would benefit from investment practices that strengthened the Union.102/

ERISA imposes on fiduciaries an obligation to act in the interests of the participants and beneficiaries which is at least as stringent as the common law obligation enforced

---

99/ Id. at 1106.

100/ Id. at 1112.

101/ Id.

102/ Recently, Blankenship has been characterized as a case "in which the trustees pursued policies which may incidentally have aided the beneficiaries of the fund but which were intended, primarily, to enhance the position of the Union and the welfare of its members. . . ." Withers v. Teachers' Retirement System of the City of New York, 447 F. Supp. 1248, 1256 (S.D.N.Y. 1978) aff'd, 595 F.2d 1210 (2d Cir. 1979).

in Blankenship v. Boyle. The legislative history evidences deep congressional concern not only with conflicts of interest on the part of employers -- such as investment in employer stock -- but also with union self-dealing. The courts have found a breach of the duty to act solely in the interests of the participants and beneficiaries where, for example, plan assets are used to pay salaries of plan employees who are principally engaged in conducting the business of the union.103/ Thus, at a minimum, the "solely in the interest" test of ERISA § 401(a)((1) prohibits any program of social investing which is founded simply on the notion that a stronger union or stronger employer would be of indirect benefit to the participants and beneficiaries.

It may be a thin line which separates investments that are "solely in the interest" of participants from those that are intended to benefit the company or the union. For example, William Sidell, Vice President of the AFL-CIO Building Trades Department, has argued that a policy of investment in unionized projects would "not only provide earnings to fund retirement benefits, but will also help assure that the plan is still ongoing by the time the participant is ready to retire."104/ Others may argue that investments strengthening the employer are necessary where the employer's financial weakness impairs its ability to contribute to the plans and thereby imperils the employees' benefits. An interesting analogy is provided by Withers v. Teachers' Retirement System of the City of New York,105/ in which the courts upheld under common law fiduciary standards the decision of the New York City municipal unions to commit more than $2.5 billion of their pension funds to the speculative bonds of financially ailing New York City. On the evidence, the district court concluded that "neither protection of the jobs of the City's teachers nor the general public welfare were factors which motivated the trustees in their investment decision."106/ Rather, the trustees had

---

103/ Marshall v. Snyder, 430 F. Supp. 1224 (E.D.N.Y. 1977), aff'd, 572 F.2d 894 (2d Cir. 1978).

104/ Testimony before President's Commission on Pension Policy (Dec. 11, 1979).

105/ 447 F. Supp. 1248 (S.D.N.Y. 1978), aff'd, 595 F.2d 1210 (2d Cir. 1979).

106/ 447 F. Supp. at 1256.

sought to maintain the City's solvency because the City was the principal contributor to the funds and the ultimate guarantor of the employees' pensions.107/ It should be noted, however, that the trustees responsible for the New York City rescue made their commitment conditional upon the passage of state legislation authorizing them to consider the need to maintain the City as a contributor to the funds and upon the receipt of federal assurances that such investments would not jeopardize the tax-exempt status of the funds under the exclusive benefit rule of Internal Revenue Code § 401.108/ Thus, Withers arguably states the exception rather than the rule with respect to investments intended to support an employer that sponsors the plan.109/

ERISA 404(a)(1) also would seem to reach self-interested conduct which is intended to generate noneconomic benefits for the plan fiduciaries. In the hearings that preceded ERISA, the Department of Labor explained that the "solely in the interest" language would require a fiduciary

> to refrain from involving himself in situations or transactions (especially transactions with known parties in interest) where his personal interests might conflict with the interests of the participants and beneficiaries for whom the fund was established.110/

107/ The court distinguished Blankenship, even though under the UMW contract the tonnage of union-mined coal determined the level of contributions to the pension funds. See note 102 supra.

108/ See 447 F. Supp. at 1258; 1975 N.Y. Laws Ch. 980; P.L. 94-236, 90 Stat. 238 (1976).

109/ Of course, such investments must also pass muster under the stringent "prohibited transaction" rules of ERISA § 406. See text at notes 147-63.

110/ I Subcomm. on Labor of the Senate Comm. on Labor and Public Welfare, 94th Cong., 2d Sess., Legislative History of the Employee Retirement Income Security Act, at 275-76 (1976) [hereinafter cited as "ERISA Legislative History"].

This section appears to prohibit a trustee from using the plan's financial resources to further his own personal moral or political objectives, without regard to the interests or objectives of the participants. Thus, it would seem that a trustee who refuses to invest in companies doing business in certain countries or producing products that he finds noxious must present, at the very least, some coherent showing that this investment policy was undertaken with some notion of the interests of the participants and beneficiaries of the plan rather than as a mere expression of his own personal objections to the policies of these companies or countries.

Of course, a trustee's reasons for engaging in a particular policy of social investment may derive from genuine concern for the welfare of plan participants and beneficiaries. For example, a policy of investment in local companies might be predicated on the thought that a stronger local economy will provide economic benefits to plan participants and their families. A refusal to invest in companies that persistently violate federal health and safety standards might rest on the premise that such financial pressure might induce these companies to change their ways and might thereby indirectly shape the prevailing standards for occupational safety in the industry in which the plan participants are employed. And the trustee's position might be fortified with a resolution adopted by the employees or their representatives endorsing a particular policy of social investment as consistent with the employees' interests.

Such cases -- where the investment is prudent, where there is no indication of self-interested conduct on the part of the fiduciary, and where the employees are arguably receiving some benefit from the proposed investment policy -- pose the most difficult issues under ERISA § 404(a)(1). The central question is whether an investment policy that confers benefits upon plan participants as part of a much larger group -- such as local residents or workers generally -- is consistent with a proper interpretation of the "solely in the interest" standard.

Because this issue is not easily resolved by the language of § 404(a)(1), it seems likely that the courts will look to the purposes of the statute as reflected in its structure and legislative history. The objectives of

the statute are set forth in its initial section.111/ The declaration of policy advanced there makes no reference

---

111/ ERISA § 2, 29 U.S.C. § 1001 (1976), provides in relevant part:

> Sec. 2. (a) The Congress finds that the growth in size, scope, and numbers of employee benefit plans in recent years has been rapid and substantial; . . . that owing to the lack of employee information and adequate safeguards concerning their operation, it is desirable in the interests of employees and their beneficiaries, and to provide for the general welfare and the free flow of commerce, that disclosure be made and safeguards be provided with respect to the establishment, operation, and administration of such plans; . . . that owing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered; that owing to the termination of plans before requisite funds have been accumulated, employees and their beneficiaries have been deprived of anticipated benefits; and that it is therefore desirable in the interests of employees and their beneficiaries, for the protection of the revenue of the United States, and to provide for the free flow of commerce, that minimum standards be provided assuring the equitable character of such plans and their financial soundness.
>
> (b) It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.

to the objective of providing nonfinancial benefits to the employees through a socially responsible investment policy, nor does it refer to any larger group of beneficiaries of the statute. Indeed, in the area of investment policy,the focus of this declaration and the accompanying findings is upon the need for fiduciary standards that will insure the financial "soundness" and "stability" of the plans.

This emphasis is understandable in light of the factual record upon which Congress acted. The hearings exposed numerous examples of self-dealing, mismanagement and inadequate funding of plan obligations. Thus, the Committee Reports stress the need for strict fiduciary standards which would insure that employees receive the benefits to which they are entitled.112/ The basic congressional concern was to find means of assuring greater financial soundness for employee benefit plans,113/ not encouraging more creative uses of plan assets.

Indeed, although several proposals designed to encourage social investing were placed before Congress, none were enacted into law. In February, 1970, Walter Reuther of the United Auto Workers, testifying before the House Subcommittee on Labor, urged that the committee "provide within the framework of [the federal] standards enough latitude so that the trustees could invest, with proper safeguards, some of those trust funds in . . . high social priority projects."114/ His remarks did not spark much enthusiasm from such key Congressmen as Representative Dent, Chairman of the Subcommittee, and Representative Erlenborn, the ranking minority member.115/

112/ E.g., S. Rep. No. 93-127, 93d Cong., 1st Sess. 2 (1973); H.R. Rep. No. 93-533, 93d, Cong., 1st Sess. 12 (1973).

113/ 120 Cong. Rec. at S15738, S15741 (Aug. 22, 1974), III ERISA Legislative History at 4734, 4743 (remarks of Senator Williams).

114/ Hearings, supra note 13, at 194.

115/ See, e.g., id. at 195 (remarks of Congressman Dent) ("I might observe that the Committee has been giving serious consideration that the prudent investor's rule be the guideline for investments in the private sector").

Later that year, Congressmen Pucinski asked Secretary of Labor George Shultz, testifying before the same Subcommittee, whether language should be written into the bill protecting investment managers who decided to invest in low income housing for senior citizen members.116/ Shultz's answer was a cautious one, submitted in written form. Despite his awareness of the need to finance low cost housing, he indicated that "care must be taken to ensure that an effort to this end does not run counter to the purposes of employee benefit plans, which are also socially desirable."117/ The Administration did not wish to "single out employee pension funds from other investment sources to bear a larger burden of riskier investments and lower yields such as would be required by section 511 of H.R. 7495 [sic]."118/ The Secretary also pointed out that the Administration bill already contained language which appeared to permit the parties establishing a plan to incorporate directions instructing a fiduciary to make certain investments without regard to the prudent man rule.119/ The language upon which the Secretary relied did not appear, however, in the final version of the bill enacted by Congress, a further indication that Congress' intent may have been to narrow, rather than widen, the scope of the fiduciary's discretion.

116/ *Id.* at 528.

117/ *Id.* at 529.

118/ *Id.* The bill to which the Secretary was referring, H.R. 17495, 91st Cong., 2d Sess. (1970), required that private pension plans and foundations with assets of more than 4 million dollars invest up to 2.5% of their net assets in the securities of a National Development Bank which would lend funds for certain socially desirable purposes. *See* 116 Cong. Rec. 21584 (June 25, 1970). The House Committee recommended deletion of this section of the bill and the House supported that decision. *Id.* at 21587-90. The bill was ultimately enacted into law as the Emergency Home Finance Act of 1970, P.L. 91-351, 84 Stat. 450.

119/ Section 14 of the Administration bill, H.R. 16462, contained general fiduciary standards and prohibited transaction rules, but provided in § 14(c)(7) that nothing in that section would be construed to prohibit any fiduciary from "following the direction in the trust instrument or other document governing the fund insofar as consistent with the [prohibited transaction rules of that section]." *See* *id.* at 10.

Later in 1973, Ralph Nader and Karen Ferguson of the Public Interest Research Group submitted a draft bill which envisioned the establishment of private, competitive retirement benefit funds which could place up to 10% of their assets in social investments. The propriety of these investments would be judged by the extent to which they reduced expenses typically incurred during retirement.120/ This proposal also drew unenthusiastic response from the House Subcommittee Chairman:

> Up to now we know of no standard that controls investment decisions better than the prudent man rule. If we want to go beyond that, we could write specific limitations into the bill.121/

Once again, Congress refused to adopt any specific provision authorizing socially dictated or even socially sensitive investment policies.

In light of these congressional responses to specific proposals for social investing, it seems inappropriate to stretch the "solely in the interest" language of § 404(a). As the Act's declaration of policy makes clear, Congress enacted ERISA with the relatively narrow objective of assuring adequate financial security for retired workers. An investment policy which seeks to improve the lot of some group of people unrelated to the pension plan participants would appear to be outside the permissible range contemplated by the statute. A more difficult case is presented by an investment policy which is intended to benefit plan participants as one small fragment of the community of American citizens or as one small segment of the community of American workers. In such situations, the investment policy would appear to be susceptible to challenge under the statute on the ground that it is not "solely in the interest" of plan participants but rather intended to vindicate the interests of a much larger group of beneficiaries.

Nevertheless, an argument can be made that where a fiduciary has narrowed his list of potential investments to alternatives which are economically comparable, the statute

---

120/ Hearings on H.R. 2 and H.R. 462 before the General Subcommittee on Labor of the Committee on Education and Labor, 93d Cong., 1st Sess. 261 (1973).

121/ *Id.* at 293.

should not preclude him from selecting the alternative which in the long run may produce indirect benefits to the participants as members of some larger group. Assuming total financial comparability under the prudence standard between two investments -- such that the fiduciary would be prepared to "flip a coin" between them -- and assuming also that the fiduciary acts without any trace of self-interest or self-vindication, it is difficult to see any harm in a socially sensitive investment policy which may produce some extra benefits for the participants. While the prospect of such benefits may be speculative, and the magnitude of such benefits for the individual participant may not be impressive, the fiduciary may aid the interests of his beneficiaries more by opting for such an alternative than by randomly or arbitrarily choosing some other alternative that offers no by-product advantages at all.122/

The problem with this analysis, however, is that its assumptions may be unrealistic. Even though several investments may be economically comparable in that they are consistent with the plan's investment objectives, they may offer slight differences in probable risk, return, and diversification value. Thus, the selection of one alternative over another might involve some small sacrifice in financial value. Once noneconomic considerations are permitted to enter into the analysis, there is a real danger that the fiduciary may be tempted to choose one investment on the basis of its perceived general utility to the community rather than to refine the comparison of financial characteristics to determine whether there is actual equivalence between the investments. A further difficulty with the premises of this argument is that the fiduciary may not be able to show that the socially sensitive policy which he has followed was intended to benefit the interests of the beneficiaries, rather than to vindicate his own interests or views. Union officials may have difficulty proving,

---

122/ In recent testimony before the Subcommittee on Antitrust, Monopoly and Business Rights of the Senate Committee on the Judiciary, Ian Lanoff, the Administrator of Pension and Welfare Benefit Programs of the Department of Labor, took the position that where two investments were equally desirable from an economic standpoint, social factors could then be considered in determining which investment to select. See Staff Report, supra note 1, at 13.

for example, that a policy of investing only in unionized companies is intended to benefit the participants as workers rather than the Union itself.

Because of these difficulties with the "no harm done" argument, it is probably wiser for a plan fiduciary to act at all times with the interests of the plan participants, as participants, directly in mind. Senator Williams, the Senate floor manager of ERISA, recently emphasized this statutory focus on the retirement interests of participants:

> [S]ituations may arise where the interests of active employees may be at odds with the retirement income security interests of those same employees or present retirees. In such cases, a pension plan fiduciary with investment responsibility must choose the course which is consistent with the primary duty of loyalty to the retirement income needs of plan participants.123/

A construction of the statute which places primary emphasis on the retirement interests of participants need not preclude all forms of social investing. A reasonable argument could be made that the Act's objective of assuring financial security for retired workers may be served by investments which not only provide a return that helps pay benefits under the plan, but also tend to reduce the expenses of plan participants during their retirement years. For example, an employee pension fund could supply capital to build low-cost housing for the elderly in a community where its beneficiaries reside. Investment in the housing which would be used in substantial part by the plan participants and their beneficiaries would appear to satisfy the "solely in the interest" standard and would be permissible if it met the prudence test. As the Senate Committee Report noted, the "most important purpose" of ERISA was "to assure American workers that they may look forward with anticipation to a retirement with financial security and dignity, and without fear that this period of life will be lacking in the necessities to sustain them as human beings within our society."124/

123/ 125 Cong. Rec. S560 (daily ed. Jan. 24, 1979).

124/ S. Rep. No. 93-127, 93d Cong., 1st Sess. 13 (1973).

Because an investment in housing for the elderly is consistent with that purpose, a court would be likely to uphold any close, judgmental decisions challenged under the loyalty standard.125/

Of course, this rationale, too, could be stretched to its limits. Will not a stronger local economy, or a free society, also benefit the plan participants in their retirement years? Perhaps, but with such a tenuous link, it is hard to say that the primary purpose of such an investment is to benefit the plan participants, rather than to achieve some other purpose for some other group of beneficiaries. Moreover, it is questionable whether such psychological benefits are among the "necessities" which Congress intended to assure for retired workers. Indeed, the language of § 404(a)(1)(A) of the Act raises some questions as to whether a fiduciary can seek to maximize any benefits other than the purely financial ones to be paid from the plan's assets, a question to which we now turn.

D. The "Exclusive Purpose" Rule

In addition to the "solely in the interest" requirement of ERISA § 404(a)(1), a second subsection describes the permissible objectives of a fiduciary in discharging his duties. ERISA § 404(a)(1)(A) further requires that the fiduciary discharge his duties:

> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan; . . .

Under standard principles of statutory construction, this exclusive purpose requirement cannot be read as a redundant reiteration of the duty of loyalty owed to the participants and beneficiaries under § 404(a)(1). Thus, there may be a strong temptation for the courts to interpret it so that it imposes some further limitation on a fiduciary's conduct.

125/ Alternatively, a court presented with a difficult issue concerning a fiduciary's motives under the loyalty standard may avoid the problem by focusing greater scrutiny on the prudence test to determine whether the investment was actually "comparable" to other alternatives.

One might argue, for example, that this provision limits the objectives of an investment program to maximizing the size and security of the fund from which cash benefits are to be paid. The language of the provision lends a certain plausibility to this argument. The command of § 401(a) of the Internal Revenue Code -- that the employer maintain the plan "for the exclusive benefit of his employees or their beneficiaries" -- has been modified. The phrasing now emphasizes that the fiduciary's exclusive purpose must be to provide benefits.126/ Although the term "benefits" is arguably broad enough to encompass all of the rewards -- moral and financial, direct and indirect -- that a participant might reap from an investment program, the term is used throughout the Act in contexts that refer to those cash benefits which a participant or his family would receive in accordance with the specifications of the plan.127/ Moreover, the word "benefits" here occupies a position parallel to the term "expenses" in ERISA § 404(a)(1)(A)(ii), so that it appears to refer only to cash benefits under the plan rather than the potential indirect benefits of an investment program. Thus, if the "exclusive purpose" rule is viewed as a restriction on the investment objectives of a fiduciary, it could have a restrictive impact which goes beyond that of the "solely in the interest" requirement, prohibiting policies which are socially sensitive as well as socially dictated investment practices.

Indeed, it should be noted that the "exclusive purpose" rule of ERISA § 404(a)(1)(A) reiterates and enforces the identical direction of ERISA § 403(c)(1), which provides:

> . . . the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.

In the original version of H.R. 2 introduced at the commencement of the 93d Congress, both of these "exclusive purpose"

126/ See also Report, ERISA and the Investment Management and Brokerage Industries, 35 Bus. Law. 189, 234 (1979) (pointing out that Conference Report implies that compliance with Internal Revenue Code is not sufficient under ERISA "exclusive purpose" rule).

127/ E.g., ERISA §§ 2(a), 3(22), 3(34), 3(35), 29 U.S.C. §§ 1001(a), 1002(22), 1002(34), 1002(35).

phrases appeared in the same section of the bill. The section entitled "Fiduciary Responsibility" began with the broad declaration, "Every employee benefit plan shall be deemed to be a trust," and then identified the "exclusive purposes" for which the trust assets were to be "held."128/ Thus, this language was conceived as a general limitation on the purposes of an employee benefit plan covered by the Act and could be viewed as a limit on the permissible investment objectives of an employee benefit plan.

There is some doubt, however, that this provision was designed for application to investment activities. Rather, it is plausible to conclude that the provision was intended to govern the expenditure of plan funds. It can rationally be construed as merely prohibiting all disbursements other than the payment of benefits to the plan participants and their beneficiaries and the payment of reasonable administration expenses. This construction of the provision is consistent with its use in early Labor Department enforcement actions under ERISA. The Department has successfully relied on this provision to attack disbursements for excessive administration fees, unnecessary expenses (such as the lease of an aircraft for the plan), and payments of benefits not contemplated by the plan or to persons not covered by the plan.129/ Because of the strength of the other fiduciary provisions discussed above, and in light of the apparent purpose of this provision to curb improper expenditures, there is little compelling need for the courts to apply this provision to investment issues.130/

Nevertheless, because of the all-encompassing introductory language of ERISA § 404(a)(1), the exclusive purpose rule could be construed to apply to the investment activities of the plan's fiduciaries. If it is to be given meaning in this context, perhaps the most reasonable construc-

---

128/ H.R. 2, 93d Cong., 1st Sess. 39 (1973), III ERISA Legislative History 41.

129/ Marshall v. Snyder, 430 F. Supp. 1224 (E.D.N.Y. 1977), aff'd, 572 F.2d 894 (2d Cir. 1978); Marshall v. Knee, No. C-33-77-93 (S.D. Ohio Dec. 30, 1977) (consent order); Marshall v. Wilson, No. 3-76-373 (E.D. Tenn. June 6, 1977) (consent order).

130/ It has also been argued that the Conference Report treats the "solely in the interest" and "exclusive purpose" requirements as equivalent, Report, ERISA and the Investment Management and Brokerage Industries, Five Years Later, 35 Bus. Law. 189, 232 & n.6 (1979).

tion would be to view it as supporting the fairly restrictive interpretation of the "solely in the interest" requirement discussed earlier in this paper. The "exclusive purpose" language suggests that trusts covered by ERISA are to be established and maintained for the limited purpose of providing retirement benefits, not for other, socially desirable purposes which provide collateral or speculative "benefits" to plan participants or appeal to the philosophical leanings of the plan sponsor or other parties related to the plan.

In summary, although there is reasonable doubt, the "exclusive purpose" language of ERISA § 404(a)(1)(A) may well be construed to produce an additional restriction on the scope of permissible investment practices. In any event, the courts may face a difficult task integrating this subsection with the prudence rule of ERISA § 404(a)(1)(B) and the "solely in the interest" language of ERISA § 404(a)(1), which independently set minimum financial requirements and circumscribe the possible objectives of an investment program.

E. In Accordance With Plan Documents

Some commentators in the social investing debate have suggested that a "key factor" with respect to the legality of social investing is the type of authorization set forth in the governing trust document.131/ This would be true in the context of private trusts, and to a limited extent for trusts covered by ERISA. Certainly, if the trust agreement explicitly proscribes any form of social investment, that prohibition can limit the trustee's investment activity. But the terms of the statute would not appear to countenance the converse proposition. Under ERISA, the plan documents cannot authorize a policy of social investment which would otherwise be impermissible under the fiduciary standards of the Act.

ERISA § 404(a)(1)(D) requires that a fiduciary discharge his duties

> in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title.

131/ R. Ravikoff & M. Curzan, *supra* note 3.

Thus, the terms of the plan are valid only to the extent that they are consistent with the fiduciary standards of § 404 and the other provisions of ERISA. Indeed, ERISA requires a fiduciary to disregard the plan documents if compliance with the documents would be inconsistent with any of the provisions of the Act. This point is underlined by ERISA § 410(a):

> Except as provided in sections 405(b)(1) and 405(d), any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty shall be void as against public policy.

The plan documents cannot, therefore, remove or relax the requirements that a fiduciary act prudently and in the interests of the participants and beneficiaries.132/ Nor can the plan documents be drafted to override other provisions, such as a fiduciary's obligation to review the investment activity undertaken by predecessor fiduciaries to the plan.133/

The legislative history of ERISA confirms this interpretation of the statute. In identical language, the Senate and House Committee Reports explain that one reason for establishing federal standards applicable to plan fiduciaries was to discard the tendency of the common law to permit deviations from fiduciary standards where authorized by the trust instrument. The common law of trusts "developed in the context of testamentary and inter vivos trusts . . . with an attendant emphasis on carrying out the instructions of the settlor."134/ Thus, if the trust document included language authorizing investments which would otherwise be imprudent or an exculpatory clause relieving the trustee from liability for a breach of trust, the common law of many states might permit this deviation from sound

---

132/ Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978) (Even though profit-sharing plan had been restructured as employee stock ownership plan, investment in employer stock would be subject to prudence and "solely in the interest" tests).

133/ Marshall v. Craft, 463 F. Supp. 493 (N.D. Ga. 1978).

134/ H. R. Rep. No. 93-533, 93d Cong., 1st Sess. 12 (1973); S. Rep. No. 93-127, 93d Cong., 1st Sess. 29 (1973).

fiduciary principles.135/ Whatever its value in the context of personal trusts, Congress viewed this principle as inappropriate in the context of employee benefit plans covering hundreds or even thousands of employees. Therefore, ERISA was designed so that a fiduciary was required to act "in accordance with the documents and instruments governing the fund unless they are inconsistent with the fiduciary principles in this section."136/

Although the plan documents cannot expand the scope of legitimate investments beyond those permissible under ERISA, these documents may direct that the fiduciaries with investment discretion give special attention to particular types of investments. If, under the circumstances prevailing at the time of the decision, such investments may be harmonized with the rules of prudence, diversification and loyalty contained in the statute, the plan documents may direct the fiduciaries to select such investments over other alternatives. The plan documents might also be useful in establishing priorities between different social objectives. It is essential, however, that these general guidelines be formulated "solely in the interest of the participants and beneficiaries." Investment guidelines tainted by other concerns would themselves be violative of the statute, no matter how much flexibility they demonstrated.

The plan documents may also allocate responsibility for making investments, including social investments, among the fiduciaries. ERISA § 405(c) permits most fiduciary responsibilities to be allocated among named fiduciaries or to be delegated to others. If the allocation or delegation of the fiduciary's authority follows the procedure set forth in the plan document,137/ the Act limits the potential liability of the named fiduciary to a specific set of

---

135/ In some states, however, such deviations were precluded by statute. *See* note 34 *supra*.

136/ H.R. Rep. No. 93-533, *supra*, at 13, S. Rep. No. 93-127, *supra*, at 30.

137/ ERISA §§ 402(b)(2) and 405(c), 29 U.S.C. §§ 1102(b)(2) and 1105(c). Conference Report at 301. *See also* Department of Labor Interpretive Bulletin 75-8, 29 C.F.R. § 2509.75-8, Questions FR-13 and FR-14.

circumstances.138/ Thus, appropriate language in the plan documents will permit the named fiduciaries to allocate to a trustee sufficient authority to manage a portion of the portfolio in accordance with a socially sensitive investment policy. In that event, the named fiduciaries will no longer be responsible for each investment decision of the trustee. Nevertheless, the named fiduciaries do remain liable for any failure to select a responsible trustee, for failure to review periodically the trustee's performance to ensure that it is in accordance with the duties of prudence and loyalty, or for originating any instructions with respect to social investing which are inconsistent with the fiduciary standards of the Act.139/

Similarly, the plan documents may authorize the trustee to delegate investment authority with respect to a portion of the portfolio to another person. The structure of the Act indicates, however, that the trustee remains liable for all investment decisions with respect to those assets unless the person to whom authority is delegated meets the definition of "investment manager" contained in the Act.140/ An investment manager must be either a bank, an investment adviser registered under the Investment Advisers Act of 1940 141/ or an insurance company and must acknowledge in writing its role as a fiduciary.142/ Thus, although a plan could utilize

---

138/ The named fiduciary remains liable only to the extent he has failed to meet the Act's fiduciary standards with respect to selection of the delegate, establishment of the procedure used to allocate or delegate authority, or termination of the delegation when circumstances require such action. ERISA § 405(c)(2), 29 U.S.C. § 1105(c)(2).

139/ Although the plan may authorize the named fiduciaries to give directions to the trustee, the trustee is subject only to "proper" directions that are "made in accordance with the terms of the plan and which are not contrary to this title." ERISA § 403(a)(1). The trustee may be held liable for following instructions which clearly on their face violate the fiduciary standards of the Act. Conference Report at 298.

140/ ERISA §§ 402(c)(3) and 403(a), 29 U.S.C. §§ 1102(c)(3) and 1103(a). See also Department of Labor Interpretive Bulletin 75-8, 29 C.F.R. § 2509.75-8, Question FR-15.

141/ 15 U.S.C. §§ 80b-1 et seq.

142/ ERISA § 3(38), 29 U.S.C. § 1002(38).

an informal advisory committee not meeting this definition to suggest various types of social investments or to recommend how stock held by the plan should be voted,143/ both the trustee and the committee remain liable under the Act for implementing any instructions of the committee.

Moreover, every fiduciary to the plan can be held liable for concealing, enabling or failing to remedy a breach of duty on the part of a co-fiduciary.144/ Thus, a named fiduciary or trustee who is aware that a co-fiduciary has exercised its investment authority to make imprudent social investments must take appropriate remedial action, such as effecting the sale of the investment,145/ or reporting the violation to the Department of Labor.146/

In summary, the plan documents can provide a framework for distributing investment authority and a list of priority investments, but they cannot expand the universe of permissible social investments, nor can they relieve the named fiduciaries and trustees of their ultimate responsibility for the safety of the plan assets.

F. ERISA's Prohibited Transaction Rules

In addition to the Act's general fiduciary standards, ERISA contains "prohibited transaction" rules which may restrict certain types of activity which are often discussed in the context of social investing. ERISA § 406(a) prohibits several kinds of transactions between a plan and a "party in interest" with respect to the plan, while ERISA § 406(b) precludes self-dealing on the part of plan fiduciaries. ERISA's prohibited transaction rules are absolute structural prohibitions; thus, the

---

143/ As noted earlier, the recent Chrysler-UAW settlement appears to contemplate this kind of advisory committee. *See* note 11 *supra*.

144/ ERISA § 405(a), 29 U.S.C. § 1105(a). Conference Report at 299-300.

145/ Morrissey v. Curran, 567 F.2d 546 (2d Cir. 1977); Marshall v. Craft, 463 F. Supp. 493 (N.D. Ga. 1978).

146/ Department of Labor Interpretive Bulletins 75-5, 29 C.F.R. § 2509.75-5, Question FR-10, and 75-8, 29 C.F.R. § 2509.75-8, Question FR-16.

"reasonableness," "fairness," or "prudence" of a transaction is irrelevant for these purposes.147/ Despite the critical importance of these restrictions, there has been little analysis of these provisions in the context of discussions on social investing.

In order to appreciate the scope of the Section 406(a)(1) prohibitions, one must take into account the breadth of the statutory definition of the term "party in interest." ERISA § 3(14) defines a party in interest with respect to a plan as including not only all fiduciaries, but also any person or company providing services to the plan, any employer or employee organization whose employees are covered by the plan, any person owning more than 50% of the employer and any relative of the persons described above. In fact, the definition of party in interest extends even further to encompass such affiliated persons as any employee, officer, director or 10% shareholder of the previously described parties and any enterprise in which those parties own an interest of 50% or more. Thus, the union and employer, and almost anyone and any company affiliated with them, will be "parties in interest" within the meaning of the Act.148/

147/ Cutaiar v. Marshall, No. 78-1380 (3d Cir. Jan. 12, 1979) BNA Pension Reporter, No. 223, at D-11 (Jan. 22, 1979). In Cutaiar, the Court indicated that:

> [T]his case involves no taint of scandal, no hint of self-dealing, no trace of bad faith. The violation was concededly a technical one, the result of a misunderstanding of the requirements of the newly enacted ERISA bolstered by the result of good faith submission of the dispute to impartial arbitration. Uncontradicted testimony before the district court established that the terms of the transaction were fair and reasonable with respect to both plans.

Nevertheless, the Court upheld the position of the Department of Labor that the transaction violated ERISA's prohibited transaction rules.

148/ See, e.g., Department of Labor Advisory Opinions Nos. 76-91, 77-14, and 78-25.

Under § 406(a)(1) of ERISA, the following transactions are prohibited:

> A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect --
>
> (A) sale or exchange, or leasing, of any property between the plan and a party in interest;
>
> (B) lending of money or other extension of credit between the plan and a party in interest;
>
> (C) furnishing of goods, services, or facilities between the plan and a party in interest;
>
> (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or
>
> (E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a).149/

Section 406(b) of ERISA imposes several additional constraints on the behavior of plan fiduciaries. Under this subsection, a fiduciary may not:

> (1) deal with the assets of the plan in his own interest or for his own account;
>
> (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party)

149/ Section 4975 of the Internal Revenue Code contains a list of prohibited transactions which is very similar to that included in ERISA § 406.

whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries; or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

These restrictions were introduced in the legislation to serve as absolute barriers to plan fiduciaries' using their discretionary authority in situations involving real or structural conflicts of interest.150/ Indeed, in this regard the Act was patterned after the earlier Senate versions of the bill which contained specific prohibitions against certain conduct, rather than the earlier House versions which merely required that a plan fiduciary meet the standard of an "arm's-length" transaction.151/ The second proscription in particular -- that prohibiting a fiduciary from representing a party with interests adverse to those of the plan -- was designed to keep "a fiduciary from being put in a position where he has dual loyalties, and therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries."152/

The prohibitions that pose the greatest potential for difficulty in the area of social investing are those contained in ERISA §§ 406(a)(1)(D) and (E) and 406(b)(1) and (2). For example, as in the Blankenship case discussed above, a union official who also served as a fiduciary to a plan covering union members might cause the plan to invest

---

150/ 29 C.F.R. § 2550.408b-2(e)(1).

151/ See Freund v. Marshall & Ilsley Bank, No. 76-C-543(W.D. Wis. Sept. 24, 1979), BNA Pension Reporter, No. 262, at D-1 (Oct. 22, 1979); 120 Cong. Rec. 15741, 15747, 15749 (Aug. 22, 1974), III ERISA Legislative History 4743, 4759, 4765 (remarks of Senator Williams on Conference Report).

152/ Conference Report at 309.

its assets in a manner intended to benefit the union. Since the union would be a party in interest under § 3(14)(D), such an investment would violate § 406(a)(1)(D), in that it would constitute the use of plan assets for the benefit of a party in interest. No actual transfer of assets between the plan and the party in interest would be necessary for a prohibited transaction to occur.153/ Moreover, an indirect prohibited transaction could occur if a plan engaged in a transaction with a person who was not a party in interest with an understanding that the non-party in interest would in turn engage in a transaction with a party in interest.154/ The above analysis would apply as well to an investment that benefited the employer who maintained the plan.155/ Also, any direct investment by a defined benefit plan in employer securities or real property would be limited to 10 percent of the fair market value of the plan's assets under ERISA §§ 406(a)(1)(E) and 407(a).156/

153/ Conference Report at 308. See Marshall v. Snyder, 430 F. Supp. 1224 (E.D.N.Y.), aff'd, 572 F.2d 894 (2d Cir.1978).

154/ 29 C.F.R § 2509.75-2. See also, e.g., Department of Labor Advisory Opinion No. 75-103 and Department of Labor Information Letter (WSB No. 78-17).

155/ For example, the Labor Department complaint filed in Marshall v. Schmoutey, No. Cir. Lv. 77-47 RDF (D. Nev., Complaint filed June 1977), alleges a violation of ERISA §§ 406(a)(1)(B) and 406(a)(1)(D) on the ground that the plan lent money to a corporation which was owned by a person who owned a corporation which owned more than 10% of yet another corporation whose subsidiary employed persons covered by the plan. See BNA Pension Reporter, No. 131, at R-1 (April 4, 1977). See also M&R Investment Co. v. Fitzsimmons, Civ. Lv. 76-114, RDF (D. Nev., Complaint filed June 24, 1976).

156/ This restriction does not apply to an eligible individual account plan such as an employee stock ownership or profit-sharing plan if the plan explicitly provides for the purchase of qualifying employer securities. See ERISA §§ 407(b)(1) and 407(d)(3), 29 U.S.C. §§ 1107(b)(1) and 1107(d)(3). Even in such plans, however, the investment in employer stock must be prudent and solely in the interest of the participants. Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978).

In addition, an employer who invested plan assets in a manner designed to promote the employer's business would most likely run afoul of the § 406(b)(1) prohibition against dealing with plan assets in his own interest.157/ Finally, any plan fiduciary who represented another party's interest -- for example, a union official serving as plan trustee and investing plan assets in order to foster the union's interests -- also might violate the § 406(b)(2) prohibition against acting on behalf of a party with interests adverse to those of the plan.158/

Although ERISA Section 408 provides several statutory exemptions from the Act's prohibited transaction rules, these provisions would be inapplicable to the types of transactions that usually arise in the context of social investing. Section 408(a) sets forth a procedure for seeking administrative exemptions from these restrictions,159/ but most prohibited transaction exemption applications dealing with investments of plan assets are handled on a case-by-case basis.160/ Additionally, it should be noted that all the administrative exemptions that have been granted by the Department of Labor and Internal Revenue Service contain specific language indicating that they do not relieve the plan's fiduciary of his general fiduciary obligations under ERISA § 404.

157/ See, e.g., Exemption from Prohibitions Respecting a Transaction Involving the Univar Retirement Plan, 41 Fed. Reg. 46799 (1976); Exemption from Prohibitions Respecting a Transaction Involving Stryco Manufacturing Company Pension Trust, 41 Fed. Reg. 48200 (1976); Exemption from Prohibitions Respecting a Transaction Involving the Given International Employees' Stock Bonus Plan, 41 Fed. Reg. 54080 (1976).

158/ See, e.g., Exemption from Prohibitions Respecting Certain Transactions Involving the Alaska Teamsters-Employer Pension Trust, 41 Fed. Reg. 16642 (1976); Exemption from Prohibitions Respecting Transaction Involving International Brotherhood of Electrical Workers Local Union No. 606 Health and Welfare Fund, 41 Fed. Reg. 30414 (1976); Exemption from Prohibitions Respecting a Transaction Involving the Iron Workers' Apprentice Fund, 42 Fed. Reg. 13633 (1977).

159/ See also ERISA Procedure 75-1, 40 Fed. Reg. 18471 (1975); Reorganization Plan No. 4 of 1978 (Executive Order 12108), 44 Fed. Reg. 1065 (1979).

160/ See notes 157 and 158, supra.

An example of the interaction of ERISA's prohibited transaction rules with a socially sensitive investment policy has occurred in the construction industry. Multiple-employer plans covering employees in the building trades traditionally have invested a percentage of their assets in construction loans to contributing employers as a means of providing work opportunities for plan participants. Even though such loans may be intended to promote the interests of plan members, they are clearly inconsistent with the structural prohibition of ERISA § 406(a)(1)(B). In order to preserve this practice, the Labor Department has found it necessary to grant a limited class exemption covering such loans.161/ The exemption places a number of important restrictions on this practice, however. For example, the loan decision must be made by an independent bank, savings and loan association, or insurance company; the aggregate amount of such loans to a single employer must not exceed 10% of the plan assets; and the aggregate amount of such loans to all participating employers must not exceed 35% of the plan assets.162/ In addition, the exemption does not protect the use of plan assets for permanent mortgage loans.163/ Thus, a commitment from a plan to a participating employer to provide permanent mortgage loans to persons who purchased improved real property from the participating employer would be prohibited by the Act.

In view of the impact of ERISA's prohibited transaction rules on at least certain kinds of "social investing," there may need to be major structural changes in the law, or major exemptions from these rules, to permit many of the types of transactions often considered in the context of social investing. The exemption process, whether individual or class in nature, would interject the Department of Labor directly into the role of deciding which "socially desirable" investments are "in the interests

---

161/ Prohibited Transaction Exemption 76-1, Class Exemptions From Prohibitions Respecting Certain Transactions in Which Multiemployer and Multiple Employer Plans are Involved, 41 Fed. Reg. 12742 (1976).

162/ *Id.* at 12743.

163/ *Id.* at 12742.

of the plan and its participants and beneficiaries," and "protective of the rights of participants and beneficiaries of such plan."164/ It is doubtful, however, whether the Department, the Congress, or the public at large would be in favor of this remedy for dealing with the problem. Therefore, a legislative remedy may be necessary.

IV. PRACTICAL ISSUES INVOLVING SOCIAL INVESTING

To date, there has been no litigation under ERISA challenging the social investment practices of private employee benefit plans. It would not be surprising, however, if such litigation accompanied the spread of social investment theory and practice. The jurisdictional provisions of the statute encourage suits by plan members and fiduciaries. In addition to litigation which may be initiated by the Department of Labor, any participant, beneficiary, or fiduciary can sue the plan or its fiduciaries.165/ The federal district courts have jurisdiction of such actions without regard to jurisdictional amount,166/ and are authorized to provide complete relief.167/ As an incentive to such suits, the statute authorizes the court to award attorneys' fees to the prevailing party.168/

As noted earlier, the prospect of litigation seems more likely in the case of a defined contribution plan. The participants in such plan will immediately feel the sting of an unsuccessful social investment and, in light of the visibility of their individual accounts, are more likely to

---

164/ ERISA § 408(a)(2)&(3), 29 U.S.C. § 1108(a)(2)&(3).

165/ ERISA § 502(a), 29 U.S.C. § 1132(a).

166/ ERISA § 502(f), 29 U.S.C. § 1132(f). An action may be brought in the district where the plan is administered, where the breach took place, or where any defendant may be found. Once proper venue is established, the district court may assert personal jurisdiction over every defendant, including, of course, all plan fiduciaries.

167/ ERISA § 409(a), 29 U.S.C. § 1109(a); ERISA § 502(a)(2)&(3), 29 U.S.C. § 1132(a)(2)&(3).

168/ ERISA § 502(g), 29 U.S.C. § 1132(g).

take an interest in the investment policy of the plan. Even in a defined benefit plan, however, a lawsuit might be prompted by the prospect that a loss of plan assets in a social investing project will preclude an increase in benefits at the next amendment to, or renegotiation of, the plan. In addition, there may be some employees who disagree with the social investment policy followed by the plan on ideological grounds or who wish to challenge the concept of using plan assets for social purposes.169/ In fact, there is always the possibility that a fiduciary opposed to risking the assets of the employer to achieve social goals might decide to challenge a program of social investment in court.

A lawsuit challenging a social investment program may have serious consequences for the plan and its fiduciaries. Most fiduciaries are aware that they may be held personally liable in damages for an investment which is found by a court to be imprudent. They may not realize, however, that they may be held liable in damages as well for any violation of the other fiduciary standards of the statute. ERISA § 409(a) states:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

Thus, if a loss ensues from a program of social investing which is not "solely in the interest of the participants and beneficiaries", the responsible fiduciaries might be required to restore the lost assets to the plan. In this situation, it is irrelevant that the social investment may have been prudent, and could have been selected by a fiduciary using

---

169/ See e.g., "Sacramento Unions Blast 'Social' Concept", Pensions & Investments 1 (Nov. 5, 1979).

only financial criteria.170/ Because these fiduciaries actually selected the investment for an improper reason, there is a possibility of personal liability to make up any losses suffered by the plan.

A lawsuit for damages is possible in the context of a defined benefit plan as well as a defined contribution plan. If the plan had experienced losses or failed to reap achievable gains as a result of a socially dictated investment policy, the plaintiff-participants could force the fiduciaries, including the representatives of the employer, to restore the lost funds to the plan.171/ While the employer is normally required to compensate for any deficiency in the investment performance of the plan's portfolio through his obligation under the funding standards of ERISA,172/ that obligation can be amortized over a period of many years. A suit for restitution under ERISA, however, could force the employer to make an immediate lump sum payment -- a greater burden than the employer may have contemplated.

Although it is less likely that a profitable program of social investing will be challenged, even in this situation a lawsuit may have undesirable consequences for the plan fiduciaries. First, a plaintiff who is successful in showing that the program was inconsistent with the fiduciary standards of the statute would be entitled to an

---

170/ Similarly, a trustee who violated his duty of loyalty under the common law would be held liable for all losses, regardless of the fairness or prudence of the investment. *See* Restatement (Second) of Trusts § 206 (1959); II A. Scott, *supra* note 30, § 170.

171/ ERISA § 409(a), 29 U.S.C. § 1109(a). *See* Eaves v. Penn, 587 F.2d 453, 463 (10th Cir. 1978); Freund v. Marshall & Ilsley Bank, No. 76-C-543 (W.D. Wis. Sept. 24, 1979), BNA Pension Reporter, No. 262, at D-1 (Oct. 22, 1979).

172/ *See* ERISA § 302(b)(2)(B)(iv), 29 U.S.C. § 1082(b)(2)(B)(iv) (authorizing the amortization of net experience losses over a period of 15 years for a single employer and 20 years for a multiemployer plan).

injunction terminating the program.173/ Removal of the responsible fiduciaries would also be within the power of the court.174/ The fiduciaries might be required to pay the attorneys fees of the successful plaintiff.175/ Thus, even in a situation where a socially dictated investment is unlikely to produce a loss,176/ there are sound practical reasons why fiduciaries may wish to avoid any deviation from the fiduciary standards of the statute.

In view of the possibility that a program of social investing will provoke litigation, the plan which embarks on such a program should construct a solid foundation. The fiduciaries must first analyze the needs and objectives of the

---

173/ Pursuant to ERISA § 502(a)(3), a participant, beneficiary or fiduciary may sue

> (A) to enjoin any act or practice which violates any provision of this title or the terms of the plan, or
> (B) to obtain other appropriate equitable relief (i) to redress such violation or (ii) to enforce any provision of this title..."

174/ ERISA § 409(a), 29 U.S.C. § 1109(a); Eaves v. Penn, 426 F. Supp. 830, 838 (W.D. Okla. 1976), aff'd, 587 F.2d 453 (10th Cir. 1978).

175/ ERISA § 502(g), 29 U.S.C. § 1132(g); Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978); Mahoney v. Union Leader Retirement Profitsharing Plan, No. 77-129-D (N.H. July 9, 1979), BNA Pension Reporter, No. 248, at D-4 (July 16, 1979) (consent order providing for payment of more than $200,000 in attorneys' fees and expenses); Kulchin v. Spear Box, Inc., 78 Civ. No. 592 (S.D.N.Y. July 28, 1978), BNA Pension Reporter, No. 208 at D-9 (Oct. 2, 1978) (awarding $9,041.25 in attorneys' fees).

176/ A violation of the prohibited transaction rules of ERISA § 406 may lead to a penalty against the party in interest amounting to 5 percent of the amount involved in the transaction and up to 100 percent of that amount if the transaction has not been corrected within 90 days of notice from the Government. I.R.C. § 4975, 26 U.S.C. § 4975; ERISA § 502(i), 29 U.S.C. § 1132(i).

may find it necessary to call on advisors with financial or investment expertise to develop a rational strategy to meet those needs. Legal advisors may be consulted as to general legal standards, but lawyers should not be expected to pass upon such primarily factual questions as the suitability of particular investments for the portfolio. In addition, it is usually more helpful to have the lawyer review the strategy after it has been developed than to have the lawyer describe at the outset what should not be done.

A key feature in the defense of any investment is the development of a rationale for the investment decision at the time it is made.177/ The Labor Department's prudence regulation, in focusing on the reasonableness of the procedures and information used by fiduciaries in making investment decisions, indicates that the Department is developing a rule based on the fiduciary's conduct at the time of decision rather than a "hindsight" test determined by economic results. Thus, prior to undertaking any socially sensitive investment, the plan should have completed an analysis showing how it will contribute to the achievement of the plan's investment objectives. Moreover, the fiduciary also should develop empirical support for his view that the investment will further the retirement interests of the beneficiaries. In the event of challenge, a social investment supported by such a contemporaneous rationale is more likely to be characterized by a court as socially sensitive (and permissible) than socially dictated (and impermissible).

Some fiduciaries may prefer to avoid such documentation on the ground that it makes it easier for a challenger to establish that social investing has occurred. Apart from the duplicity of this approach, it seems naive to think that any effective policy of social investing can be hidden from discovery. On balance, a policy of social investing is better protected by a documentary foundation which permits an effective defense than by efforts at concealment which are likely to provoke the curious to investigate.

This principle of developing contemporaneous support does not mean that every decision to include or exclude an investment must be supported by a separate,

---

177/ *Cf.* In re Morgan Guaranty Trust Co., 396 N.Y.S. 2d 781, 784 (1977); Stark v. United States Trust Co., 445 F. Supp. 610, 680 (S.D.N.Y. 1978).

extensive analysis. Where adequate empirical data is available, it may be possible to develop more general guidelines which permit the fiduciary to include or exclude groups of investments. The point is simply that the evidence supporting such guidelines should be considered prior to implementing them, rather than developed or examined for the first time when the issue is raised in court.

Not all social investments will lead to litigation. In the absence of any explicit regulatory guidance or definitive judicial decisions, it is difficult to state with precision whether a particular investment policy will be found in violation of the law. Even where an investment may seem to press the outer limits of ERISA's fiduciary standards, there may not be anyone with a sufficient financial interest to challenge the investment. In light of these practical considerations, the fiduciary must decide what degree of comfort he will demand from the law and empirical data supporting his investment decisions. While the possibility of litigation should be considered, in many cases it will be viewed as simply another risk created by the investment policy.

V. SUMMARY

The legal framework established by ERISA is both comprehensive in its coverage of the activities of plan fiduciaries and complex in the restrictions it places on their management or disposition of plan assets. Thus, any summary of its application to social investing risks the possibility of a misleading oversimplification. Reduced to its essence, however, ERISA appears to require that every plan investment be subjected to a three-part analysis.

In the first part, the responsible fiduciary must determine whether the financial characteristics of the investment will satisfy the prudence and diversification requirements of the statute. The fiduciary must evaluate the safety, return, marketability, and diversification characteristics of the proposed investment in order to determine whether, in the context of the plan's entire portfolio, the investment will aid the plan in achieving its investment objectives. Those objectives in turn should have been formulated with due regard for the plan's design, funding, liquidity needs, and other individual characteristics. Thus, the financial needs of the plan will lead to the establishment of investment objectives designed to meet

those needs. In turn, those objectives can be achieved through the use of investment strategies which utilize one or more groups of economically comparable investments for inclusion in the plan's portfolio. While a fiduciary may be able to invoke a socially sensitive investment policy in order to select among these alternative investments, a socially dictated investment policy, in which financial comparability is sacrificed in order to achieve some social purpose, will not withstand scrutiny under this part of the statutory analysis.

In the second part of the analysis, the fiduciary's actions in selecting particular strategies or investments must be reconciled with the purposes declared permissible by the statute. If there is any element of self-interest in the choice of investments, whether that interest is financial or ideological, then the statute may well prohibit such conduct. Even where the fiduciary acts without regard to his own interests, it is nevertheless essential that the investment program be designed primarily to further the interests of participants and beneficiaries. If the fiduciary faces a choice between investments whose financial characteristics are identical, it may be possible to choose an alternative which offers indirect benefits to plan participants as members of some larger community. But in light of the difficulty in proving both a pure motive and financial equivalence, it may be more sensible to develop an investment policy which is designed to permit only those investments which aid the interests of the plan participants as participants. Under this criterion, then, even some socially sensitive investment policies could be rejected as inconsistent with the objectives of the statute.

Finally, each transaction must be consistent with the structural standards of ERISA. If the investment will benefit a party in interest such as the employer or union, the plan may find it necessary to obtain an exemption from the "prohibited transaction" rules of the statute. In all events, the investment decision must be made in accordance with the plan documents.

The application of this analytical approach may be illustrated by considering two current issues in the social investing debate. First, there has been considerable commentary suggesting that a plan fiduciary will find it easier under the law to exclude certain investments because of their supposed social deficiencies than to

affirmatively select other investments because of their perceived social advantages. The argument runs that exclusion is more likely to be permissible because the fiduciary is simply "crossing out one firm from a universe that has a huge number of options."178/

Although from a practical standpoint it will be difficult to establish financial loss when a fiduciary eliminates a limited number of investments from a large universe of acceptable alternatives, it makes relatively little difference from a legal perspective whether the fiduciary proceeds by a method of exclusion or inclusion. The critical questions are, first, whether the investments that the fiduciary is considering have the financial characteristics that satisfy the plan's investment objectives, and second, whether the fiduciary's criteria for choosing or eliminating some investments within this acceptable universe are designed to further the retirement interests of the plan participants and beneficiaries. The use of a socially sensitive investment policy to guide the affirmative selection of investments is permissible as long as the investments are prudent and the policy is designed primarily to further the interests of the plan participants and beneficiaries. On the other hand, the statute would appear to prohibit the exclusion of even a limited number of investments within the acceptable universe on the basis of self-interested goals such as benefiting the company or the union.

Of course, the breadth of an exclusion policy -- the number of investments excluded under the investment policy -- may be of some relevance in deciding whether that policy can be harmonized with the prudence and diversification requirements of the statute. Where a socially dictated investment policy requires the exclusion of an entire category of investments, it may preclude the fiduciary from achieving one of the plan's investment objectives. For example, one study found that exclusion from the Standard and Poor's 500 of all companies with business interests in South Africa would eliminate all major multinational firms and essentially eliminate many major industries, such as computers, international oils, major chemicals, and automobiles.179/ In these circumstances, a fiduciary's efforts to

---

178/ "Social Investing: A Volatile Issue Surfaces," Pensions and Investments 24 (Oct. 23, 1978) (quoting Professor Roy A. Schotland).

179/ Heritage Investment Advisors, Inc. study discussed in Mares Draft; Pensions and Investments 6 (Nov. 5, 1979).

achieve appropriate diversification may be stymied. Another recent study of the market performance of the top 99 institutional holdings concluded that those 39 companies deemed "socially irresponsible" by the Corporate Data Exchange Study[180] had performed slightly better over the past five years than the 60 presumably "responsible" companies.[181] Without exploring the precise significance of these studies, we can infer that a broad exclusion policy may require the sacrifice of some element of safety or return. On the other hand, a veto over just a few stocks, such as that reportedly granted to the U.A.W. in the Chrysler settlement, is not likely to preclude the fiduciary from finding equivalent investment opportunities.

Once the "prudence" hurdle has been cleared, the policy must then be squared with the "solely in the interest" standard. As noted above, when dealing with a situation where the benefit to plan participants is difficult to identify and yet no evidence of self-dealing appears to be involved, courts may well re-examine the prudence issue and if satisfied on that score, elect not to force a "random choice" notion of selection.

A second area of controversy in the social investing debate in which the legal framework of ERISA can provide guidance is the voting of shares owned by the plan. As noted earlier, the fiduciary standards of ERISA § 404 clearly apply to such activities on the part of plan fiduciaries. The prudence rule of § 404(a)(1)(B) prohibits the fiduciary from voting the shares in a way that would jeopardize either the safety or return of the plan's investments. The "solely in the interest" test of ERISA further proscribes any attempt by a fiduciary to use voting power to further the fiduciary's own interests.[182] But apart

---

180/ *See* note 12 *supra*.

181/ Robert A. Levy of Computer Directions Advisors, Inc. found that 39 "bad guys" had produced an average gain of 83.5% over the past five years (exclusive of dividends) whereas the 60 other leading holdings had gained only 76.8% in the same period (exclusive of dividends). "Social Investing could hurt fund performance: CDA study;" *Pensions and Investments* 35 (Nov. 19, 1979).

182/ *Cf.* Blankenship v. Boyle, *supra* note 98.

from these broad constraints, the fiduciary probably has relatively broad discretion in voting the plan's shares. For example, corporate law recognizes that those who control corporations may choose to sacrifice immediate financial gain in the pursuit of a socially responsible policy which will yield good will or an improved business environment.183/ As a practical matter, a plan fiduciary may be able to justify most of his votes on social issues with the explanation that the socially responsible course of conduct was in the best interests of the corporation and therefore protective of the financial viability of the retirement fund. It would only be in an extreme case where the use of voting influence could jeopardize the financial integrity of the underlying entity.184/

These examples illustrate the extent to which a fiduciary may consider social factors in discharging his duties under ERISA. We find no support in the statutory

---

183/ A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, appeal dismissed, 346 U.S. 861 (1953) (donation to private university); Union Pacific Railroad Co. v. Trustees, Inc., 8 Utah 2d 101, 329 P.2d 398 (1958) (donation to private foundation); Kelly v. Bell, 254 A.2d 62 (Del. Ch. 1969) (payment in lieu of taxes to local governments). See generally 6A. Fletcher, Cyclopedia of the Law of Private Corporations § 2938 (1968); Blumberg, Corporate Responsibility and the Social Crisis, 50 B.U.L. Rev. 157 (1970).

184/ See the remarks of Senator Williams, floor manager of ERISA, in debates on the ERISA Improvements Act of 1979:

> Stressing once again that the ERISA fiduciary rules are designed to achieve a goal of great social importance, the supplying of retirement or deferred income and health and welfare benefits, there is no question in my mind that those rules permit the exercise of stock voting rights in a way that is consistent with other social concerns of the plan's participants and beneficiaries except in the rare case where such action would measurably impair the security of plan assets or adversely affect the plan's economically sound investment objectives.

125 Cong. Rec. S560 (daily ed. Jan. 24, 1979).

standards for the proposition that a fiduciary must adopt a socially sensitive investment policy.185/ The legislative history of ERISA suggests considerable congressional antagonism to any such requirement. Moreover, the highly structured allocation of investment responsibilities permitted by the Act, under which a trustee or investment manager is given only limited duties and powers with respect to a portion of the plan's portfolio, constitutes a serious barrier to any effort to vest the investment manager with responsibility for making social as well as financial judgments on behalf of all of the plan's participants. Finally, in light of the complexities inherent in defining social policies that are in the interest of participants, in setting priorities among those policies, and in developing criteria for measuring corporate compliance, it is difficult to imagine that a court would engraft on the otherwise mute language of the statute a judicial requirement that plan fiduciaries undertake such an arduous analysis.

* * *

If the analysis in this paper produces the sense of a restrictive legal environment, it is because ERISA and its legislative history suggest that significant barriers presently exist for fiduciaries who might use employee benefit trust assets in order to achieve their own notions of socially desirable objectives. While there appears to be some room within the legal framework of the statute for socially sensitive investment policies which are intended to promote the retirement interests of beneficiaries, the Act appears to proscribe policies which sacrifice financial comparability or promote the interests of third parties in pursuit of some broader social objective. If this regulatory framework is found to be unsatisfactory, there may well be need for appropriate legislative change. Until that time, however, it ill behooves any fiduciary covered by the Act to embark on a program of social investing without first carefully analyzing the limitations contained in ERISA.

185/ For a more extensive exposition of this proposition, see K. Ferguson, Social Investing: An Advocate's Perspective (1979), infra.

The Advocate's Arguments: A Review and Comment

Karen W. Ferguson

THE ADVOCATE'S ARGUMENTS: A REVIEW AND COMMENT

There are a great many advocates of social investing. Each of us has our own arguments, unique perspectives and differing conclusions. Nonetheless, I think that it is fair to say that most of us agree on a number of basic principles.

All of us start from the premise that pension fund money belongs to workers and retirees. It is their deferred wages held in trust for the sole purpose of being invested to further their interests.

We all agree that pension fund money must be invested prudently and that the retirement income security of participants and beneficiaries must be protected at all costs. As a corollary of this principle, we do not think that the pensions of participants and beneficiaries should be placed at risk without their consent. We also do not think that employers should bear increased risks.

Social investment advocates are uniformly critical of current investment practices that seek only to maximize yield consistent with safety. We point to the fact that in the short run these practices are in many instances hurting the people whose money is being invested and we contend that in the long run they are undermining the efficient operation of the capital market system.

While in complete agreement that social investment is essential to further the well-being of participants and the economy, social investment advocates disagree as to who should make the social investment decisions and what factors those decision makers should take into account.

The "social activists" who precipitated the current debate take the position that unions and state governments should make the decisions as to where pension fund money is invested. Their argument is based on the fact that union officials and state legislators are the elected representatives of the people whose money is being invested and, therefore, can best reflect their interests. Other groups call for investment decisions to be made by investment committees directly elected by participants and beneficiaries and still others leave the investment responsibility in the hands of professional trustees.

The interests social investment advocates would like to be served by pension fund money are also differently defined. These interests range from the personal retirement income interests of particular participants, through the general well-being of participants, through the general well-being of participants as individuals and as members of larger communities, to the broader moral considerations that some advocates would like to see made an integral part of fund investment practices.

Fortunately, the entire spectrum of social investment advocates is represented at this Forum and since each participant has been assured ample opportunity to state his or her own views, I will avoid risking the possibility of misstating the arguments of others and devote the remainder of this paper to discussing our own approach to the issues. For lack of a better catch phrase the position we advocate could be termed "participant" as opposed to "political" or "strategic" investing.

The Center is, as many of you know, a nonprofit public interest group committed to protecting and promoting the interests of pension plan participants and beneficiaries. Most of our activities over the past three and a half years have focused on the fact that too few people are getting pensions and that those getting pensions are, for the most part, getting too little. Our starting point is the interest of American workers, retirees and their spouses in a secure retirement income and we approach the social investing debate from that perspective.

Interestingly enough, we find ourselves in agreement with the opponents of social investing on a number of key points. We agree that protection of the retirement income security of participants and beneficiaries must be the paramount concern of fund trustees. We agree that fund trustees have the primary responsibility to preserve that retirement income security. We also think that the basic structure imposed by ERISA makes sense and is consistent with the interests and needs of participants and beneficiaries.

Where we disagree--and disagree strenuously--is with the opponents' contentions first, that conventional investment practices adequately preserve and protect the retirement income security of participants and second, that ERISA's fiduciary provisions do not require that trustees take factors other than yield and risk into account.

Our position is that the retirement income security of participants can only be protected if certain social considerations are taken into account and that the fiduciary provisions of ERISA make sense only if they are read to require fiduciaries to take those social considerations into account.

The Theoretical Framework for "Social" or "Participant" Investing

The social investment debate has already made some progress. Had this Forum been held a year ago, opponents of social investing

would be arguing that ERISA precludes fiduciaries from taking social considerations into account. Thanks in large measure to statements by Senator Harrison A. William, Jr., and Ian D. Lanoff, there is now widespread agreement that all things being equal, pension fund trustees can, consistent with their fiduciary obligations, take social factors into account.

This Forum provides an excellent opportunity to take the debate a few steps further. It provides an opportunity to arrive at a consensus that, at a bare minimum, all other things being equal, trustees not only can but must take at least certain social considerations into account. I think we should also be able to agree at this Forum that even where all things are not equal there are certain situations in which pension fund trustees have a duty to seek the consent of participants and beneficiaries and, if such consent is forthcoming, take specific social factors into account.

If we can agree on these two basic premises, they can serve as a springboard for discussion of other more controversial positions taken by social investment advocates. Even more important, they will provide the framework for focusing on the entirely separate practical issue of how to incorporate social considerations into the investment processes.

The first point on which we should be able to reach agreement is that pension fund trustees have a duty not to invest in such a way as to jeopardize the retirement income security of the people whose money is being invested.

My reason for thinking that we should be able to agree on this principle is that it makes obvious good sense. An interpretation that would permit trustees to invest pension fund money to undercut the pensions of participants would make a mockery of fiduciary responsibilities.

The principle is also supported by the intent and the language of ERISA. Although my task is not to set out the legal framework justifying social investing, there are a few factors that deserve emphasis and which otherwise might be overlooked.

The ERISA prudence standard is based on the common law prudent man rule. At common law it would have been self-evident that a pension fund trustee could not invest pension fund assets in such a way as to diminish or deny pensions to fund participants. The rule stated unequivocally--as it still does for personal trusts--that trustees in investing fund assets must consider the same factors that a reasonable prudent man would take into account in investing his own money. Since no reasonable prudent man would be so shortsighted as to invest his money to undercut his own interests, "social" considerations would automatically be factored into the investment processes.

To take an example. Under the common law standard it would be unthinkable for a pension fund trustee faced with several equal yield, equal risk investments to choose an investment in a company seeking to undercut the wages and working conditions of the company employing the participants in the plan making the investment. The trustee would avoid such an investment because the reasonably foreseeable consequence of the investment would be that the participants would at lease find it more and more difficult to push successfully for increased pensions or less restrictive qualification requirements. If their company were ultimately forced out of business by the competitor, they would lose their jobs and with their jobs their chance to accrue additional pension benefits. In addition, some participants would lose nonvested pension benefits, and others would have their benefits only partially insured or possibly not insured at all. In short, the investment of their own money would be the cause of their future retirement income insecurity. Since no pension fund trustee would make this kind of investment on his own behalf he would be precluded under the common law rule from making it on behalf of another.

The ERISA prudence rule differs from the common law rule in only one respect. It substitutes an institutional standard of conduct for the old personal standard. The purpose of the new standard was not to reduce the responsibilities of fiduciaries. Rather it was meant to add to those responsibilities by requiring that all fund trustees follow the types of procedures and exercise the kind of judgment characteristic of institutional trustees.

Specifically, the ERISA prudence rule was meant to replace the "enlightened amateur" standard of the common law with the standard of the professional trustee. The new rule was suggested by the American Bankers' Association as a way of discouraging nonprofessionals from serving as Taft-Hartley trustees. The thought was that abuses in Taft-Hartley funds could be stemmed by encouraging their trustees to give up their authority to institutional trustees. Congress in adopting this new standard certainly never intended to free trustees to engage in conduct that would not have been permissible at common law.

The requirement that trustees consider the participant impact of their investment decisions that is implicit in the ERISA prudence rule is made explicit in its exclusive benefit rule. That entirely separate rule specifically requires that trustees discharge their duties "solely in the interests of participants and beneficiaries."

The origin of the exclusive benefit rule is the common law "duty of loyalty." At common law this duty meant that trustees were barred from using their positions of trust to advance their own personal financial interests. In a pension context this duty makes it unlawful for trustees to consider their own institutional interests at the expense of plan participants.

For example, a Taft-Hartley trustee representing a union cannot when he is sitting as a fund trustee consider the union's interest in using pension fund money to assist in an organizing campaign. His obligation is solely to the plan participants and beneficiaries, not to the union's institutional interests. Similarly if a bank trustee made investment decisions exclusively on the basis of risk and return because this approach assured the bank of higher profits or was simply the easiest thing for him to do, he would run afoul of the duty of loyalty.

As written, the ERISA exclusive benefit rule is not limited to a prohibition against conflicts of interest--in fact, there are several far more effective bans on self-dealing elsewhere in the Act--instead it imposes on plan trustees the very specific obligation to look with an eye solely on the interests of the individuals for whose benefit the trust was created. The rule means what it says, namely that trustees cannot ignore factors that affect the retirement income security of participants and beneficiaries. It means that in equal yield, equal risk situations a trustee, who knows that the reasonably foreseeable consequences of an investment will be to diminish the retirement income of participants or beneficiaries, violates the ERISA fiduciary standards if he or she makes that investment.

If we can agree on this one principle, that trustees cannot knowingly invest pension money in such a way as to undercut participants' pensions, we will have recognized the legitimacy of social investing.

Putting problems of implementation aside for the moment, I think we may be able to agree on two further points.

First, not only do the ERISA fiduciary provisions make it unlawful for plan trustees to invest participants' money in such a way as to thwart their pension interests, they also impose on trustees an affirmative duty to select from among equal yield, equal risk investments those that will enhance the retirement income security of plan participants.

Trustees have traditionally taken the position that their responsibilities are limited to providing a return on investment sufficient to enable the plan to pay the dollar amounts specified in the plan documents. That position is understandable but it is also unrealistic.

A retiree's retirement income security depends not just on receiving a specified amount each month but on the relationship of that dollar amount to current and anticipated expenses. What good is even a large pension if it is not sufficient to purchase essential goods and services? We read the ERISA fiduciary provisions to require that in equal yield, equal risk situations where trustees have knowledge that the reasonably foreseeable consequences of an investment will be to increase the "real retirement income" of participants to a greater degree than other

investments, the trustees have a duty to act "solely in the interests of participants and beneficiaries" and make that investment.

As example of this type of situation would be one where there is a shortage of housing in an area where large numbers of plan participants live. Assume that the plan trustees learn of a high yield secure housing investment in the area. (It could even be senior citizen housing.) Although other equal yield, equal risk investments are available, the trustees could best serve the "real retirement income" interests of the participants by making the housing investment. They would accordingly, have an obligation under ERISA to choose this investment over the others.

A final point on which we may be able to reach agreement goes to situations where yield and risk are not equal. A fiduciary obligation may also arise in these situations, but the nature of the obligation is somewhat different.

Assume a situation where an investment would further the interests of participants and beneficiaries but carries with it a higher risk or lower yield than other investments. An example might be an investment in a medical clinic serving retired plan participants. Although the trustees can reasonably foresee that the medical clinic will substantially lower the cost of health services to participants, thus increasing their real retirement income, they are also aware that there is a remote possibility that the clinic, although project to be profitable, might ultimately fail. Plainly, the trustees cannot unilaterally assume the risk on behalf of the participants. They can, however, ask the participants whether they are willing to assume the risk. If the participants agree to accept the possibility of diminished future benefit increases or, in the event of plan termination, frozen partially insured or noninsured benefits in exchange for the improved retirement income status produced by the clinic's lower medical costs, the trustees would then be required to make the investment.

What I have discussed thus far are the areas on which I think we can get a consensus at this Forum. From the perspective of most of the other social investment advocates, the approach I have suggested is likely to be too modest--Randy Barber and Jeremy Rifkin have said that "modest proposals are for gentle times." Nonetheless, we feel strongly that if we can get a consensus on a few first principles and begin developing the techniques for implementation, we will have made a very significant start.

<u>Practical Implementation of "Social" or "Participant" Investing</u>

In the theoretical framework just discussed I pointed out that trustees <u>must</u> take social considerations into account only if they know <u>or have</u> reason to know the reasonably foreseeable consequences of the available investment alternatives. Unless

there are institutionalized procedures for trustees to acquire this knowledge in the ordinary course of business with a minimum of effort and expense, the extent of fiduciary responsibility in the social investment area is likely to be extremely limited.

Considerable work remains to be done in refining the techniques that will enable trustees to learn about the needs and interests of participants. One method for ascertaining those needs and interests on a regular, routine basis would be for plans to take advantage of the unique opportunity afforded by the summary annual reports now required to be furnished to all participants once each year. It would be a simple matter to include a brief statement in each SAR asking participants their views on the investments made by their trustees the preceding year and their suggestions for alternative investments. Where appropriate, the trustees could also include in the SAR additional questions relating to specific investment or proxy voting issues.

The investment preference information provided in the SAR would provide the trustees a general sense of the participants' concerns based on past investment experience. Where there is a need for a more immediate response, the trustees could use a variety of communications techniques. For example, if a key proxy vote was about to be decided, the trustees could request participant input by putting ads in the classified section of local newspapers, making spot radio announcements, including articles in union and company publications and posting notices.

If action by the trustees required authorization by participants and beneficiaries, as in the case of higher risk, lower yield investments, pay check and benefit check enclosures could be used.

To eliminate the burden on plan trustees that might otherwise be created by the flow of information and to provide a mechanism for facilitating the expression of views, particularly in pooled trust situations, investment advisory committees could be created. Where there is limited interest in investment issues on the part of plan participants, the advisory committees could consist of volunteers. Where interest is strong, they could be elected. In all instances the committees should include an equal number of active workers, retirees and beneficiaries. In pooled trust situations representatives from the advisory committees could participate on a rotating basis in a pooled trust advisory committee.

The information provided through these and similar techniques will make it possible for trustees readily to discern the types of investments most likely to help and least likely to hurt the retirement income security of the people whose money they are investing. It is also worth noting that there is very little cost or administrative burden associated with these techniques.

If recent developments are any indication, trustees are also likely to have another very important source of information,

information coming from unions and consumer, citizens', public interest and retirees' groups.

These groups are in a position to establish that there is a relationship between a particular investment and the retirement income security of a specific group of participants. For example, they are likely to be able to establish that an investment in a designated nonunion company will ultimately undercut the pensions of a particular group of participants. They also may be able to show the relationship between the general needs of a community--for example, for community redevelopment--and the specific retirement income needs of targeted groups of participants within that community. Conceivably, they might even be able at some point to document such things as the extent to which excessive concentration of a pension fund's assets in top tier stocks adversely affects the real retirement income of participants by increasing the costs of essential goods and services. They can present the trustees with new ideas for high yield, imaginative alternative investments. Special government guaranteed bonds are one example. The information provided by these groups can provide the basis for trustees to act to further the interests of the participants.

This is not to say that the trustees necessarily have to agree with the groups urging them to act. In many cases they will not. If they disagree, they can detail their reasons in an investment impact statement. Such statements could be kept on file at the Labor Department with the plan's Annual Report Form. If the groups are unpersuaded by the investment impact statement, they are at liberty to file a lawsuit charging that the trustees' action or inaction violated the ERISA fiduciary provisions. As a practical matter, however, a well-reasoned impact statement is likely be be an ample defense to such a suit.

In no circumstances would trustees be bound to adhere to a single set of criteria, lists of investments to be included or excluded. The Corporate Data Exchange and similar studies would be extremely useful to union and consumer groups seeking to take certain factors into account but the existence of those factors would not in an of themselves be controlling. For example, the CDE study might be useful in showing that a particular union negotiated pension fund is heavily invested in the stock of a nonunion company but unless the nonunion company's wages and working conditions could effectively undermine the participants' wages and working conditions (and therefore their pensions), the trustees would be under no ERISA obligation to avoid investing in the nonunion company. Studies such as the CDE study are likely to become increasingly more sophisticated and therefore of even greater relevance to investment decisions.

As will become quite evident in the course of this Forum our position differs most markedly from that of other social

investment advocates in our rejection of the notion that unions--and state governments--should assume a more dominant role in the investment processes.

We recognize that unions are the elected representatives of many plan participants. At the same time unions are not representative of all participants, even in negotiated plans. Our experience, moreover, has been that the pension area is fraught with conflicts of interest for unions.

The conflicts that bear most directly on investment decisions are those arising from their obligation to represent active workers to the exclusion of retirees, those created by their interest in using all available resources to promote unionization, those that result from their interest in having access to fund monies (and their consequent opposition to prohibited transactions rules) and those that encourage them to side with management in opposition to meaningful disclosure. There are other conflicts as well, most often a result of their institutional interest in protecting longer service members, but what they all reduce to is the fact that, at lease from our perspective, the unions have temporarily forfeited their right to speak for all participants.

This is not to say that unions do not have an important role to play in the investment processes. They are likely to serve as the single most effective conduit of participants' views. More than retiree, consumer or any other kind of group they have the resources to communicate the interests and needs of workers to trustees.

A final point on the issue of more direct involvement by the unions in investment policy is that to the extent they are encouraged as plan sponsors to seek to set investment guidelines, companies will similarly become involved. This is directly contrary to the thrust of ERISA's provisions seeking to disengage plan sponsors from plan investment practices. (I might add that for the same reasons we completely oppose the concept of a "pass back" of proxy votes to plan sponsors.)

We also reject the suggestion made by other advocates that state governments should take the taxpayers' point of view in the investment processes. The money invested in public pension funds is not public money. It is the deferred wages of state employees and retirees. Once contributions have been made, the state's taxpayers cease to have any legitimate interest in the fund.

We have opted for leaving investment decision making in the hands of professional trustees largely by default. Professional trustees are all we have. It is true that right now they are disclaiming any interest in looking beyond risk and return but it is equally true that they have shown a certain degree of flexibility in the past. After all, pension funds are now investing in the top 200 stocks rather than only the top 50 and Morgan

Guaranty Trust Company proudly touts the results of its investments in small businesses. Besides if they do not inject some degree of creativity into the investment processes, they will all be replaced by computers.

In conclusion, I would like briefly to focus on the use of pension fund money for purposes other than providing retirement income. In equal yield, equal risk situations, there is no reason why pension fund money should not be used to meet the shorter term economic needs of participants or the broader social needs of their communities if there is a consensus on the part of the participants that this is an appropriate use of their money. Similarly, there is no reason why they should not be able to express their moral concerns through the investment of their money (or the voting of their pension proxies).

A difference between this situation and those where the investments impact on the participants' retirement income security is that the burden of determing whether there is a concensus that the funds be used in these ways will be entirely on the participants and beneficiaries or their advocates. They will have the responsibility of providing a binding referendum--with active workers and retirees being polled separately. While this will be a relatively easy task for certain groups, it will be a virtual impossibility for others.

An even greater difference between this situation and those where participants want to invest in consumer loans, day care centers and similar projects or to have their proxies voted against apartheid, is that in these situations there is no ERISA obligation to invest the pension fund money in these ways. It may be possible to bring pressure on the trustees but the pressure will be political and not legal. Unlike their employers, participants do not have the power to change fund trustees when they are dissatisfied with their investment practices.

Of course, if trustees persist in refusing to invest funds in accordance with the wishes of participants, there is the very real possibility either that the unions will seize control of fund investment decision making or there will be a strong demand for pension trust arrangements that permit participants to select their own trustees.

Six years ago the late Senator Philip Hart stated that the future battle for control of pension capital will "be the central structural and policy problem of the American economy and society for years to come." Interestingly enough Senator Hart made that statement in connection with his introduction of legislation that proposed to restructure existing pension funds to give participants, among other things, the right to select their own trustees.

Rumor has it that certain members of the investment community are expecting this Forum to put an end to the debate on social

investing. I hope they are right. I hope that as a result of this Forum members of the investment community will be ready to stop talking about social investment and start putting it into effect.

The Opponent's Arguments: A Review and Comment

Roy A. Schotland

Divergent Investing for Pension Funds:

unsafe for retirement security,
ineffective as a means to reach the divergent goals,
but valuable in provoking re-examination of traditional prudent investing and re-discovery of better means to reach the divergent ends

Acknowledgment

Participants at the EBRI Forum on December 6, 1979 and other readers as well were most generous in their careful comments on the draft of this paper. Doubtless some errors remain, new ones may have entered, and other items are here though some might deem them errors.

I deeply appreciate the comments and interest, which went beyond improving this paper to improving my own understanding. The final paper reflects my limits despite their aid.

In this paper I have used data being assembled by others but not yet published, as well as attempting some first-time assembly. Thus there may be particular need for correcting figures or even concepts, and the reader is assured that any corrections or suggestions of error would be most welcome. Of course the welcome would be no less warm for corrections of errors of any type.

Summary and Table of Contents

		Page
I.	Introduction	112
	--"social" investing? Divergent or alternative investing	
	--"moderate" divergent investing, trying to preserve retirement security	
	--the unreality of "moderate" divergent investing	113
II.	A bit of history of divergent investing	114
	--general	
	--Wisconsin's	
	--that history's seven lessons	115
III.	The forces fueling the advocacy of divergent investing	116
	A. The need to demonstrate the fallacies	
	B. One force is simply how attractive the notion sounds, and how unpersuasive have been some arguments against it	117
	C. More important is the sincere hope to meet society's problems by tapping what look like huge, under-utilized resources	
	D. Also fueling this advocacy is the mediocre performance of traditional prudent investing for pension funds	120
	--comparison between Becker's employee benefit universe and Lipper's mutual fund universe, over 17, 10 and 5 years	121
	--comparison between CDA's bank pooled equity accounts and CDA's mutual funds, 1969-79, with and without risk-adjustment	122
	--the importance of improving investment performance	123
	--the easy sin of hindsight	127
	...the advocates of divergent investing add to hindsight the "selective" use of facts	128

Page

...the facts about returns on equities and fixed-income securities, 1900-78

...further compounding hindsight, the advocates ignore relative riskiness 129

E. The final force fueling this advocacy: the need to have something to advocate, plus hypocrisy 130

IV. The prime objection to divergent investing is that it interferes with retirement security 131

--a goal agreed upon by employers and employees

--a goal recognized and furthered by the Tax Code

--an "exclusive benefit" for four decades in the Tax Code, three decades in Taft-Hartley and since 1974 in ERISA 132

--the reason for the legislative litany of "exclusive benefit": retirement costs dwarf pension assets 133

...corporate plans' costs 134

...state and local plans' costs

...the relative cost rise still ahead for state and locals far exceeds the rise for private plans

...the impact of inflation, therefore the need for more retirement security, not divergence from it 136

V. The limits of "moderate" divergent investing, which recognizes the exclusive primacy of retirement security 139

--already followed. . .

--but cannot go far enough to matter. . . 140

--and cannot assure the alleged protection of retirement security 141

Page

VI. Even if divergent investing is chosen, the problems of implementing it 142

A. Which goals?

B. Once the divergent goals are chosen, what priorities among them? 143

C. Who decides?

--the problems of employees' representation, and the special problem of retirees' representation 144

--the New York City example 145

--Taft-Hartleys 146

--Corporates 147

--representativeness is not enough: the need for expertise

D. The severe lack of information on which to base fair or effective divergent investment decisions 148

--herein an "audit" of CDE's Sept. 1979 "Social Audit of Pension Investing"

...Flaw one: double counting, a lack of integrity 150

...Flaw two: black-listing bigness 151

...Flaw three: the shallowness of bigotry

...Flaw four: looking through one eye 152

...Flaw five: seeing in monochrome a world that is polychrome 153

...Flaw six: unrealism 154

...Flaw seven: disregard for investment returns 155

--results of auditing the "audit" 156

...social performance data can be assembled, but is costly

Page

...therefore concerned firms and institutions should join together to assure sound, periodic data: such data will be useful to many firms, and will facilitate experimentation more valuable than infinite debate

E. Conflicts of interests with the "target" of the divergent investing 157

--"pork-barrel" politics has safeguards that its intrusion into pension investing will lack

F. Difficulty of measuring either investment performance or performance toward divergent goal 159

--therefore loss of accountability of investment managers

VII. Even if divergent investing is implemented, will it matter?

A. The problem of "displacement"

B. The problems of "leakage" and "multipliers" 160

C. The problem of "interference" 162

VIII. Alternatives Superior to Divergent Investing 164

A. Increased mortgage-related holdings

B. Joint participation with other, independent financial institutions 169

C. Direct subsidies and other direct methods

D. Pass-through of proxies 170

E. Shareholder activism 175

Conclusion and Guiding Principles 178

Tables and Charts

Table 1: Pension Fund Holdings as Percentages of Total U.S. Financial Assets

Table 2: Historical Risk Premium Evidence-- Annualized Ten-year Rates of Returns: S & P 500 Stock Index and S & P High-Grade Bond Index

Chart 1: Chart for Table 2

Chart 2: Historical Returns Adjusted for Inflation-- Annualized Ten-Year Rates of Return: S & P 500 Stock Index and S & P High Grade Bond Index

Chart 3: Like Chart 2, on S & P 500 Stock Index and Treasury Bills

Chart 4: Like Chart 2, on S & P High-Grade Bond Index and Treasury Bills

Table 3: Mortgage Holdings of 10 of the 11 Largest Building and Construction Trades Union Pension Funds

Table 4: Mortgage Holdings of 19 State Pension Funds

Appendix: Minnesota State Board of Investment Resolution on Additional Investment Criteria and the Voting of Proxies

I. Introduction

One of those more-heat-than-light issues is "social investing", the question whether pension funds should diverge from their traditional goal of maximizing investment return at an appropriate level of risk, in order to pursue other goals. Analysis suffers from the outset if the label "social" or "socially responsible" investing is accepted, since few minds will be open to any plea for the anti-social or irresponsible, and hardly any more will think "let the market decide" a sufficient answer. But further, the "social" label is over-broad. Everyone agrees that investing for retirement security is itself a socially responsible goal. More accurate labels would be "alternative" or "divergent" investing, since the proposal is to tap pension assets for goals other than retirement security.

Some advocates of alternative or divergent investing do not go so far as to advocate any step --whether it would involve seeking out favored investments, or avoiding disfavored ones-- which might impair a pension fund's pursuit of protecting retirement security. Other advocates are prepared to diverge quite openly from the traditional exclusive primacy of retirement security.

Whatever the label, surely it sounds attractive to invest both to protect retirement security and also to promote such other goals as equal employment opportunity or environmental quality, or local jobs or housing. If "Investment XX" has as high a return and low a risk as other clearly appropriate investments but XX also promotes common concerns of the pension fund's beneficiaries, then the only investment manager who wouldn't buy XX for that fund would be a misanthrope, hating both his clients and his own firm's future. Obviously, XX has more bang for the buck.*

---

*Use of the symbol "XX" is not meant to imply that such an investment has twice as much "bang", merely that it does have something extra.

Lest there be quibbling over what is the most accurate label in this discussion, I proposed at the EBRI discussion on December 6 that we use (1) "T" for traditional investing; (2) "XX" for what I call moderate divergent investing or what James Hutchinson refers to as "socially sensitive" investing (which troubled both Jeremy Rifkin, co-author of "The North Will Rise Again", and me); and (3) "X" or the recent favorite all-purpose label, "banana", for any investment which accepts possible or probable lower returns or higher risk.

In fact, I believe the "divergent" label is precisely accurate, and its accuracy accounts for its potency in piercing the euphemistic "social" label.

Some optimists believe there are enough XX-type investments available, and that pension fund selection of such investments is so feasible and would have such beneficial impacts, without any impairment of retirement security, that no real dispute exists between traditional prudent investing and advocates of alternative divergent investing. Whether I am a pessimist or a realist, I fear that more than a failure of communication underlies the dispute here. The controversy is genuine because, for one reason, not all advocates of divergent investing will settle for XX-type investments, since by definition such investments can meet market levels of return, and some advocates' whole point is that there are worthy needs which cannot meet market tests and therefore should be subsidized by the deepest pocket available, pension assets. Of course the market system leaves some worthy needs unsatisfied, and I agree that many of these needs warrant government intervention. I am not one of those true believers who believes that markets provide the best answers to all problems except the three obvious needs for collective action, traffic lights, an army, and subsidy to my own business.* But not only do I believe that tapping pension assets for hidden subsidies to further other goals is an especially ineffective way to pursue those other goals, still more importantly I reject any divergence from protection of retirement security.

Even with the moderate advocates of divergent investing, who also reject any impairment of retirement security but believe the true path is to pursue what I have labeled XX investing, there are real differences and not merely poor communication. For XX investing is so obviously desirable that it must suffer some hitch or it would sweep the field on its own, without advocacy.

There are a number of obstacles to be overcome before we get to the happy state in which all funds so inclined can buy as much as they wish of XX investments, which actually promote alternative goals without subsidizing those goals at the expense of the retirees, or the pension sponsors, or both. These obstacles are the various difficulties of implementing any divergent investing (developed fully below): (1) Which goals shall be pursued, (2) what is the priority among them, and (3) who decides? After hurdling those obstacles, one comes to (4) the problem of identifying which investments have the desired something extra, then the problems of (5) conflicts of interests between the fund and the "target" of the divergent investment, (6) measuring how well the investment contributed to the divergent goal, and (7) trying to ignore the contribution to that other goal while evaluating how the investment performed for the pension fund, lest the exclusive primacy of retirement security begin to erode. These problems of implementation, considered fully below, are reminiscent of

---

*See my opening to "The Deregulation of the Banking and Securities Industries" (eds. Goldberg & White), An Overview: New Myths and Old Realities, (D.C. Heath, 1979).

the old cartographic problem of mapping Utopia, which is described as an incomplete circle of 50 miles in circumference with a width of 200 miles, a combination impermissible in Euclidean space. While it might be possible to draw a non-Euclidean map of Utopia, an obvious course, no one has done so even though many of us do not like the shape the world is in. Implementing divergent investing may seem equally feasible until tried. It is just like Will Rogers' formula for getting rich in the stock market: "Buy a good stock and hold it till it goes up and then sell it. If it don't go up, don't buy it."

II. A Bit of History

Before focusing on the basic objection to divergent investing and the various implementation problems that limit even XX investing, we should note the history of this idea, for it not only gives us a sense of context but, unsurprisingly, brings out several of the most important points right at the outset.

Ten years ago, Wright Patman was pushing a bill to require private pension funds to invest as much as 2-1/2 percent of their assets, each year, in low and middle-income housing. Congresswoman Martha Griffiths chaired Joint Economic Committee hearings to explore whether pension funds should be directed, by law, into "socially responsible" investments.* While the Federal scene has since then been free of this debate, there are recurrent proposals, some with pressure behind them, aimed at state and local pension funds.** But the earliest, most complete and most illuminating bit of history comes from one State.

The earliest explicit advocacy of divergent investing was in 1931 in Wisconsin, when a state assemblyman proposed to have the State Teachers Retirement Fund emphasize investment in Wisconsin farm mortgages. The assemblyman said that the fund's board had "more confidence in the Dominion of Canada, Puget Sound, and God knows where than in the State of Wisconsin." Further inquiry revealed that although the fund's 10-year losses on farm loans had been less severe than their losses on bonds (remember, this was 1931), the number of such loans had been reduced. In 1932, the Democratic candidate for Governor pledged "to wrest control of the state investment board from big business and replace it in the hands of the people to be operated for the public good." That

---

*See my testimony in Hearings on Investment Policies of Pension Funds, before Joint Economic Committee, Subcommittee on Fiscal Policy, 91st Cong. 2d Sess. (April 1970), pp. 110-34.

**Starting last year, an inter-agency study led by the Department of Housing and Urban Development, being carried out by the Urban Institute and Municipal Finance Officers Association, includes an inquiry into state and local practices, law, and pressures related to alternative investing.

candidate won, and a bill was passed mandating that at least 70% of trust monies be invested within Wisconsin. It specified preference for small loans on improved farm property, loans to co-operative and mutual organizations, and town mutual insurance company mortgages, in that order of priority.

That statute mandating in-state preference was repealed in 1945. As admitted by a recent report advocating resurrection of such treatment, "the performance level of the Wisconsin portfolio may have had a bearing on the [repeal] . . . ."* In 1949, investment of state funds again became a major issue, and a study commissioned by the Governor revealed that the state still was not performing as well as private investment managers with funds of similar size, because the State's investment policies still were not sufficiently diversified. By 1951 a major overhaul of the retirement fund structure was in place, including a great increase in investment flexibility.

For me, this bit of history makes seven points: First, divergent investing is not a new notion, but one which has been around and around, and its almost complete rejection in actual practice says much. Second, divergent investing is, in fact, hardly worth the effort to get it into place if it involves picking merely the limited number of what I call "XX-type" investments: the effort is likely to be aimed at using pension assets to subsidize other goals. Third, subsidizing other goals costs money, i.e., the pension fund will perform less well. Fourth, the funds most vulnerable to divergent investing are the state and local funds. They combine political vulnerability with unusually large assets, making it more worthwhile to bring pressure on them. New York's and California's public funds alone exceed $35 billion in assets. The top 25 public funds hold $99 billion, in contrast to the other group vulnerable to pressure for divergent investing, Taft-Hartleys, where the top 25 hold $11 billion. If private pension professionals care about this issue, they will not lie back while their state and local funds -- in which they have interests as taxpayers as well as professionally -- are pressured into diverging from protection of retirement security. Fifth, divergent investing is likely to be tried here and there, now and then, until the lesson is learned that this is just one more situation proving there is no free lunch. Sixth, injecting divergent goals into traditional pension investing is unusually likely to follow the "Law of the Austro-Hungarian Generals" --always fight the last war, aiming

---

*Wisconsin Center for Public Policy, Investment Targeting: A Wisconsin Case Study (1979), at 121. The remainder of this history, curiously omitting mention of the repeal, is at id., pp. 16-17.

The report's advocacy of another try is a triumph of hope over experience. The study itself cost $180,000.

with the perfect accuracy of hindsight. The unmet social needs which are likely to be injected into the pension program are inescapably those which have been around long enough to build up a constituency, and by the time they succeed in diverting the pension investment strategy to trying to do what should have been done openly and directly by some other instrument at some earlier time, the odds are high that needs have changed, markets have changed, and so there is even less likelihood of the divergent investment's accomplishing its divergent goal, whether or not it imposes lower return on the pension fund. Vulnerable as are investment professionals themselves to this same Law of the A.-H. Generals, far better to maximize flexibility and prudent professionalism, than to inject and preserve the war-cries of fading causes. Seventh, if and when divergent investing is tried, two safety factors must be put in with it: (A) Use only a modest portion of the assets, not all. If in fact the program does work, despite my analysis of all the reasons it won't, then the assets so used can always be increased. If it doesn't work, the lesson is learned at a much lower cost. (B) Do not reduce investment flexibility. As the recent Wisconsin report advocating divergent investing acknowledged:

> A major drawback to this approach [of statutorily defined priorities] is that it might reduce the [State Investment Board's] flexibility in making investments. To be held to even semi-rigid guidelines laid down by statute could result in an inability to act prudently in times of rapid economic change.*

III. The Forces Fueling The Advocacy of Divergent Investing

If divergent investing really won't work, and if its advocacy keeps coming up but takes hold in practice little if at all, why not ignore it? Because, for one reason, to the extent that divergent investing is tried, it is too likely to impair investment performance, and therefore impair retirement security (or the fiscal health of the fund's sponsor, whether private or public). Efforts to avoid such impairment seem to me part of the fiduciary's obligation. For another reason, even debate over this issue is an unproductive distraction from the real issues and tasks of the pension world, the simple ones like (1) improving communication to participants, (2) improving investment managers' reporting of their performance results, (3) making governance of pension funds more representative; or the tough current challenges like (4) coping with inflation, (5) coping with unfunded liabilities, (6) deciding how to provide multi-employer plans with termination insurance, (7) improving private pension benefits' integration with Social Security so that we avoid a tax-subsidized private pension scheme providing benefits mainly to the upper-income people who need such subsidy least, and

---

*Wisconsin Case Study, supra, at 238.

(8) bringing state and local pension plan norms into the modern era. The sooner we do the educating necessary to put the divergent investing issue back on the shelf, the sooner we get back to problems needing much analysis and generating such controversy as to merit all the energy we can bring them.

Advocacy of divergent investing won't stop unless the notion's unreality and unsoundness are made clear. One force raising the issue is that it does sound so attractive--"all other things being equal, why not invest for other goals as well as retirement security?" It takes some familiarity with finance to understand just how fallacious a notion this is, and neither familiarity nor sympathy is increased when pension professionals respond with various neanderthalisms, like "we must pursue only financial returns," or "we must protect the solvency of the fund"*--as if the fund mattered more than its beneficiaries, or as if the beneficiaries' only concern is financial return. Pension professionals must muster more patience and more persuasiveness to meet the wholly sincere concerns which produce much of this advocacy.

Importantly fueling this advocacy is the hope to get around the clash between the need to meet our society's problems, and the limited resources available to meet them.** At least since 1973, when the sheiks of Araby took revenge for the Nineteenth Century (to use Giscard d'Estaing's immortal phrase), our economy is not

---

*Whether or not such "answers" are as neanderthal as I say, they reflect a deeper problem noted by Daniel Moynihan: "The difficulty is simply that a mind attuned to the market place acquires an almost trained insensitivity to nonmarket considerations." From his Arthur K. Solomon lecture, NYU School of Business, Apr. 29, 1971, p. 43.

**A regional problem has been used as the fulcrum of a recent book devoted to divergent investing, the catchily-entitled "The North Will Rise Again." As was said by a friendly reviewer in a friendly journal (Matt Witt, former editor of the UMW Journal, writing in The New Republic, Sept. 16, 1978, pp. 22-3), "This is not a book which should be judged on the fine print." A few examples and points should suffice to show that however noble the authors' goals, their work has such carelessness, inconsistency, and penchant for lamentation rather than analysis, facts, or prescriptions, as to render the book a disservice to its own cause.

(1) The main cry of the book is for union pension funds in "Graybelt" states to start investing locally. No attention is paid to: (a) What will happen if funds in the area growing more rapidly in wealth, the "Sunbelt," start pursuing the same policy? (Interestingly, earlier this year an investment management firm in Houston started offering a "Sunbelt Index Fund," based on data showing that

(Footnote continued on next page)

growing as it had for the prior generation, and slower growth means more scrapping over who gets how much. Pension assets are

---

(Footnote to p. 116, continued)

equity investment there has considerably outperformed other equity investment.) (b) What will happen to Graybelt pension fund beneficiaries if their local investments perform poorly, or even just less well than more national (or international) investments? (c) Would such indirect support to the Graybelt economy be effective at all, let alone as effective as more direct steps such as regional development banks, ESOPs, pooled investment in inner cities, etc.? (d) To what extent are the problems of the Graybelt not even the result of capital shortage, but rather of a secular transition of the older part of the nation, a problem already enjoying substantial self-connection? (e) Don't the interests of marginal current workers, who might benefit from non-economic local investments, diverge from the interests of retirees and others who have vested stakes in the pension funds?

In response to concerns this book prompted among four Congressmen in the Northeast-Midwest Coalition, the Northeast-Midwest Institute did "research to analyze whether or not these claims [that their region is being "redlined" by pension fund capital] can be substantiated." The study concluded "that the above claims, on their face, are simplistic and misleading. The more accurate observation is that key factors such as relatively high costs of labor, land, transportation and energy have helped make the region less competitive." Anne Kaufman, An Analysis of Current Issues in Pension Fund Investment Practices (April 1979), p. 1.

Thus even a source highly sympathetic to seeing "the North rise again," finds the book fallacious. Coming to the same conclusion after full economic analysis is George J. Borgas, Union Control of Pension Funds: Will the North Rise Again? (Inst. for Contemporary Studies, San Francisco, 1979).

Since it is not this paper's purpose to refute fantasy about regional economic cycles--by examining, e.g., such differences within the "North" as New Hampshire's sharp rise in contrast to Massachusetts' problems, or why even the latter are turning around --the above references, citations therein, and the recent state-by-state study by Chicago's Harris Bank economists Genetski and Chin, should suffice.

(2) The book rests on the premise that our Federal union, with free flow of people, goods, services and funds throughout the nation, is less desirable than a Balkanized America. Not that the efficient division of labor and economies of scale are weighed and found wanting, but rather that the book ignores such facts of life. I'm with the majority who do not want to resurrect the Articles of Confederation.

so huge--over $400 billion now**--that they are bound to be visible, bound to seem an available resource, and bound to seem ever more ripe for tapping as they grow faster than almost any other sector of the economy, private pension assets rising over 10% each year, and state and locals 12-15% each year.

(Footnote to p. 116, continued)

(3) The book is closer to dream than reality. For example, the State of Pennsylvania did take special steps to aid the location there of a new VW assembly plant. The book grossly overstates the state aid involved (the alleged $135 million loan is over two times the actual aid), and grossly understates the gain: "a measly 2,000 to 5,000 private-sector jobs." (P. 173).

(4) The book is strikingly slipshod. It says the generations-old "prudent man rule" is a "new term" introduced by ERISA, the 1974 Pension Reform Act (p. 102), and it cannot decide whether the funds it is discussing amount to $500 billion (p. 10), $406 billion (at book, or $438 billion at market, p. 234), $200 billion (pp. 10, 81), or $125 billion (p. 236).

(5) The book is so inconsistent as to be at war with itself. For example, it laments use by corporate pension sponsors of their pension assets for their corporate goals, but applauds state or local government use for governmental goals. State and local employees who are the beneficiaries of their employers' plans are evidently less worthy of concern than corporate employees. One of the clearest examples of the book's "wanting-it-both-ways", is this:

> "Take, for example, the Wisconsin State Life Insurance fund. Founded as a self-supporting state-owned business in 1911, this insurance company provides Wisconsin residents with the least expensive life-insurance costs in the United States. . . . This incredible difference is partially a result of the fact that the Wisconsin Fund has such a small overhead compared to private insurance companies. Because it has no advertising costs and no sales commissions to pay out, its administrative expenses are virtually zero compared to industry giants like Prudential. Unfortunately, because of a strong lobby by the private insurance industry over the years, the fund has been unable to expand its mandate to cover larger premiums and to diversify into other insurance areas. As a result of that and its legal restrictions on advertising and solicitation, it has remained small." (P. 203).

** Not counting any Federal pensions.

A third force fueling this advocacy is the sad truth that traditional prudent pension investing has not done well at winning those financial returns which, it is argued, must be the exclusive concern if retirement security is to be protected. Everybody knows that our economy, and therefore our securities markets, have done poorly in recent years. But the mediocrity of pension investment performance cannot be so easily excused.

Before considering the striking inferiority pension fund performance data reveal when compared to mutual fund performance data, three points must be noted. First, the data below are limited to equity performance only. All mutual funds combined hold only about 10% of their aggregate assets in fixed-income securities (not counting money market funds and municipal bond funds). Therefore it seems meaningless to compare total portfolio performance, and immaterial to compare fixed-income performance. Second, one of the main themes in the art of argument, whenever confronted by any comparison, is to stress how many differences exist which undercut the comparison. But if the comparison shows a substantially greater difference than would have been expected (or, depending upon what point the comparison is being used for, if it shows a greater similarity), then the comparison's point must be met head on, the data may need adjustment and explanation but they cannot be explained away. Of course the data below have limits, as noted in the lengthy footnote to the table, but the performance differential these data reveal overrides any "corrective" adjustments. Third, the inferiority of pension fund performance revealed here is confirmed by two new studies done by mutual fund professionals but thorough, fair and based on neutral data sources.*

Noting how inferior has been pension fund performance, and speculating about the causes of such inferiority, is only a point in passing in this paper, even if it is a point so important that this paper would probably be unnecessary if pension funds had performed well. But the need for research into this point, to explain why pension funds have suffered such inferior performance, is as irrefutable as the data themselves:

---

*John C. Bogle and Jan M. Twardowski, Comparative Equity Investment Performance: Banks, Investment Counselors, Insurance Companies and Mutual Funds, forthcoming publication in Financial Analysts Journal; Investment Company Institute, Perspective on Mutual Fund Activity, Rpt. No. 4, Oct. 18, 1979, at 35-36, and ICI Associate Economist Jos. F. Sumanski, A Performance Comparison of Mutual Funds and Bank-Pooled Funds, Nov. 21, 1979.

A/ Comparing Performance of Becker's Pension Fund Universe and Lipper's Equity Mutual Fund Universe* (Each compared to S. & P. 500, with dividends reinvested)

	Becker's Employee Benefit "Universe" (about 3,300 accounts now, total assets: $82 billion)	Lipper's Equity Mutual Fund Universe (total assets now: $36.6 billion)
1. 17 years (back to beginning of Becker data) 12/31/61-12/31/78	Median total return: 104.6%	Median total return: 142.71%
	88% underperform S.&P. in their equity performance;	50% of 129 equity funds underperform S.&P.;
2. 10 years, 9/30/69-9/30/79	Median total return: 46.1%	Median total return: 56.40%
	88% underperform S.&P. in their equity performance;	63% of 244 equity funds underperform S.&P.;
3. 5 years, 9/30/74-9/30/79	Median total return: 111.9%	Median total return: 117.34%
	58% underperform S.&P. in their equity performance;	36% of 311 equity funds underperform S.&P.;
4. Average (mean) size of fund, roughly, as of 1979	$25 million	$96 million

*First, some of the data warrant explanation:

1) It is unusually difficult to beat the S.&P., for many reasons not pertinent here. The point of Comparison A/ is rather how very wide is the margin between the pension funds and the mutual funds.

(Footnote continued on next page)

B/ Comparing Performance of CDA's Bank Pooled Equity Account Universe and CDA's Mutual Fund Universe

--- Annualized Rates ---

Period down to 6/30/79	CDA Bank Pooled Equity Accounts (102 primarily employee benefit pools, total assets now: $3.2 billion)		CDA Equity Mutual Funds (220, total assets now: $29.3 billion)	
	Total Return	Risk-Adjusted Total Return	Total Return	Risk-Adjusted Total Return
1 year	13.0	-0.3	15.6	1.5
3 years	5.6	1.0	9.8	5.3
5 years	8.1	-0.3	11.9	2.9
10 years	3.0	-1.6	3.4	-1.0

Source: A.G. Becker & Co., Lipper Analytical Distributors, and Computer Directions Advisers, each made special efforts to furnish these data. Their aid and permission to use their data are greatly appreciated.

(Footnote to p. 121, continued)

2) The CDA data are annualized rates of total return, not the total return over the full 3, 5 or 10-year periods; and they are not medians but unweighted means.

3) The "risk-adjusted total return" ("alpha") figure states how good the actual performance was in light of how much, or how little, risk the fund(s) took on as compared to the whole market. The figure is arrived at as follows: "Riskless" return is the return on Treasury bills. If T-bills' total return was 8.6% for the year 6/30/78-6/30/79 (as it actually was), then that 8.6% is compared to the total return on the S. & P. 500 (as the proxy for the whole market) in order to derive the "market risk premium" an investor in equities received for taking on more risk. (In a bad year, the risk "premium" can be negative.) Thus since the S. & P.'s total return was 13.5% for 6/30/78-6/30/79, the "market risk premium" was 5% (actually 4.96%, the earlier figures being rounded).

If a fund or group of funds took on no more risk than the market generally (to state that in terms of one numerical measure, a "beta" of 1.0), the fund(s) would underperform or outperform the market simply by securing a total return under or over the market's. But if the fund(s) took on, say, 1/8 more riskiness than the market (a beta of 1.125), then the fund(s)

(Footnote continued on next page)

For the purposes of this paper, suffice it to say that no refutation of divergent investing could be as convincing as strong investment performance via traditional prudent management. Unless and until we get such performance, we must argue, and from a defensive posture.

(Footnote to p. 121, continued)

should enjoy 1/8 more "risk premium" than the market's. Thus if the market as a whole returned 5% more than T-bills, the 1/8-riskier fund(s) should have a risk premium of 5.625%, or for 6/30/78-6/30/79, a total return of 14.225%.

Since the CDA equity mutual funds were 1/8-riskier than the market but had a total return of 15.6%, they exceeded by 1.375% (rounded on my p. 11) their expected reward for the riskiness they assumed. On the other hand, the CDA bank pools, which took on only 95% as much risk as the whole market, were expected to have a "risk premium" of 4.75% above T-bills, or a total return for 6/30/78-6/30/79, of 13.35%. Since in fact those pooled funds returned only 13.0%, they had a negative risk-adjusted total return of 0.35% (rounded on my p. 11).

4) The CDA bank pools are not under as great diversity of management as the Becker universe. Similarly, the Lipper group of mutual funds are probably more diverse, in terms of kinds of managements involved, than the earlier Becker groups, since such large portions of the latter were managed by a relatively small number of huge bank trust departments.

Apart from explaining these data, there are four specific limitations on the data requiring mention, in addition to the general observation that no data are perfect reflections of reality, and problems expand as one group is compared with another, as different data sources are used, and as one reaches back to years when the data may have been less refined in the case of pension funds.

1) The mutual fund "universe", especially over the 17-year period, performed somewhat less well than these figures, because particularly poor performers fall away, as by merger into better performers. Adjusting for this "survival bias" would probably make a substantial difference. On the other hand, because of disclosure required by law, the mutual fund data includes all relevant funds, whereas the CDA bank pool data (and to a far less significant extent, the Becker data, which do not involve public disclosure of named accounts' performance) rely on voluntary entries and exits by the accounts under evaluation.

2) The mutual funds performed somewhat better than these figures show, because their performance is net of expenses (e.g.,

(Footnote continued on next page)

For purposes of argument against divergent investing, some pension professionals think the best answer goes along these lines: "First get the participants to agree to change their plans from defined benefit to defined contribution, so that the risk of any lower investment returns is borne wholly by the

---

(Footnote to p. 121, continued)

management fees, brokerage commissions and other transaction costs, etc.), whereas the pension fund performance is reduced by transaction costs like brokerage, but not reduced by management fees. Adjusting for this difference would probably not matter significantly. Moreover, the figures here are portfolio performance figures (subject to the qualifications noted). For actual returns to investors, mutual fund performance would be reduced in the case of "load" funds by up to as much as 9.3% of original assets invested; no reduction would be needed for "no-load" funds.

3) Because of the greater riskiness assumed by mutual funds compared to pension funds, the former should clearly outperform the latter, when both are compared against the S. & P. The CDA mutual funds' "relative riskiness" or "beta" for the three years down to 6/30/79 was 1.12, the CDA bank pools' was 0.95. On that basis, the bank pools should "underperform" the S. & P., the mutual funds should "outperform", as compensation for riskiness assumed. On the other hand, Bogle and Twardowski, supra, point out that for the era they studied (one to ten-year periods up to end-1977), the mutual funds' higher riskiness is a difference "in the 'wrong' direction to explain the mutual fund superiority, because a higher risk level would normally tend to result in lower returns in a period such as the decade we studied, when the equity market return was generally lower than the risk-free return . . . ."

4) The Becker data exclude returns on cash and cash equivalents, since for those accounts it is so difficult to separate "equity cash" from "bond cash". In a period of poor equity returns, e.g. the 10-year period noted here, that exclusion lowers the pension fund return figure below what it actually was. On the other hand, in a period of strong equity returns, e.g. the 5-year period noted here, that exclusion raises the pension fund return figure above what it actually was.

Having explained the data and noted their limitations, all the limitations fall away as insignificant in light of the breadth of the margin between the mutual funds and the pension funds. Going beyond the data, then, to speculate: Why such a difference? Of course views will differ. Before stating brief views, three differences between pension funds and mutual funds must be noted:

(Footnote continued on next page)

participants." However, that is merely a debater's point, since such a change is not readily made, and we will not remove interest in divergent investing by debaters' logic, but by demonstrating

---

(Footnote to p. 121, continued)

1) Pension funds face one challenge that mutual funds face far less: Since mutual funds are essentially equity investors, while pension funds must not only pick among equities but also must decide when to increase or decrease the equity portions of their portfolios, it may be that much of the inferior performance of the pension funds results from the inherent difficulty of "market timing" rather than from inferior equity selection. While the impact of market timing is much studied, it has not yet been examined in the pension fund-mutual fund comparison. However, there is evidence that the mutual funds' superiority is at least partially attributable to superior investment strategy apart form any impact of market timing: Bogle and Twardowski found a relationship to broader diversification and less reliance on large-capitalization issues and growth stocks. That finding withstood a test for mere coincidence with the recent years' strength of secondary issues.
Because all the performance data above are time-weighted, market timing would not have any effect on the Becker data since cash is not included there, and would have only a modest effect on the CDA and Lipper data, which do include some cash and other non-equity holdings.

2) Mutual funds face two challenges that pension funds face much less or not at all: It does not matter to the pension fund or pension fund beneficiary whether investments produce capital gains or ordinary income, but it does matter to the mutual fund holder. Query, however, how much mutual fund managers consider tax factors. The second challenge is that mutual funds have basically unpredictable cash in-flows and out-flows as the funds' shareholders redeem or increase their holdings. While past experience furnishes some guidance, it is nothing like as reliable as the pension funds' specifically known inflows and actuarially predicted out-flows. Of course a specific pension fund manager depends upon the account sponsors' judgment whether to raise or lower --or cut off-- continued cash flows to that manager, but such decisions usually come with more advance warning than moves by a mutual fund's faceless horde of public shareholders, and such decisions fluctuate far less than mutual funds' cash flows.

3) Mutual funds are far more active traders. Pension funds, whether commingled or managed separately, not only have much lower turnover but are considered to have a much more long-range orientation. The longer-range orientation might invalidate performance comparisons for selected short periods, but in no way does it reduce the validity of comparison over substantial periods.

(Footnote continued on next page)

what works and what does not. We need research on the reasons for poor pension fund performance, and we need to take steps toward improving performance. Mediocre investment performance by the private pension system exposes it not only to arguments against traditional prudent investing, but even calls into question the justification for having a private pension system.

(Footnote to p. 121, continued)

As for views on <u>why</u> mutual funds so out-perform pension funds:

In the past 3-6 years, partly because of ERISA's impact in raising awareness of pension costs and fiduciary obligations, partly because of economic externalities, competition for management of pension fund assets has become much more intense than it had been. While that statement is unarguable, many believe that the heightened competition has had little to do with the pension managers' investment performance. My own view is that even if performance still does not matter as much as it should --self-defeating though it may be for pension fund sponsors to give much weight to anything other than soundly evaluated investment performance-- pension funds' performance has come to matter more and more. Therefore, I believe that we see in Comparison <u>A</u>/ above, and will see much more, a narrowing of the margin between pension fund and mutual fund performance. I must concede that my view is not easily sustained, as to the recent past, in light of the CDA data in Comparison <u>B</u>/ above, plus the Bogle-Twardowski data showing that commingled and separately managed pension accounts performed all but identically.

One authority, Michael Lipper, cites the following reasons for the superiority of mutual fund performance:

1) Mutual fund management has been more competitive, since for many funds the sole key to getting more assets under management has been to draw them in with strong performance, and for all funds performance was a key aspect of any selling effort. In contrast, pension fund management might hold accounts, and secure new accounts, because of client relationships.

2) Thus, mutual fund management spends more time on the portfolio, less on client relations. The fact that mutual fund managements usually advise only a few accounts, while bank trust departments or investment counsellors may manage hundreds, increases the mutual fund management's advantage in time allocated to portfolio management.

(Footnote continued on next page)

Even if the exclusive pursuit of investment returns had been more successful than it has been, the less that people know about investment the easier they find it to look back and say how clearly it would have done better if it had been done differently. I am aware of no line of activity in which success and failure are so explicitly revealed, as investment management. Today many second-guessers scoff that savings accounts have done better than the stock market over so much of the last decade, and they are correct as far as that goes. But how many such scoffers called any turn in advance?

(Footnote to p. 121, continued)

3) Mutual fund managers tend to be more entrepreneurial in personality, less likely to adhere to consensus views. Their personality difference from pension managers is explained on the ground that their organizations tend to be smaller, even though the average mutual fund may be much larger than the average pension account; and the more enterpreneurial personalities are attracted to smaller organizations where they are more free of bureaucratic structure, where they may enjoy higher compensation, and where they can rise to the top.

4) Although mutual funds have some broad investment policy guidelines, their management discretion is far more free than in the case of pension accounts, where sponsors often impose restrictions limiting their own managers' discretion and flexibility.

5) Mutual fund managers are more alert to how their portfolio is doing because of the SEC requirement of daily pricing; most pension accounts are valued only monthly. (Bogle and Twardowski, *supra*, list this *first* among their five "qualitative factors which may help to explain the mutual funds' apparent performance superiority. . . .")

6) Mutual fund managers get more aggressive oversight from their boards, because for all the scepticism about the value of having outside "disinterested" directors (required by the Investment Company Act), the boards--even the inside directors--have been more probing than are the boards or investment committees of the large trust departments or insurance companies.

7) Last, pension fund managers invest more defensively, since they are more likely than mutual fund managers to be sued if they err.

8) Bogle and Twardowski add that the larger account size of mutual funds may afford them a comparative advantage.

Their advice now may be as helpful as was the Ford Foundation's in 1968, when they urged university endowments to abandon as obsolete their conservative investment policies and instead enjoy the greater benefits of growth-stock investing, just as events were making that advice one of the worst strategies of all.

The easy sin of hindsight is compounded by two errors in the advocacy of divergent investing. For one, today's relatively high yields on, say, inner-city mortgages, are compared with actual, total investment returns over the last decade. But the 5% mortgage yields of as recent times as 1961-5, or the 7-8% yields of 1971-2, are ignored.* Similarly ignored are the investment returns of the 1960's or of the last 20 years, or the comparison between fixed-income returns** and the returns on equities. How do we know whether the next decade's total returns from traditional prudent equity investing (using the S. & P. 500 as a proxy) will average an annual rate of 3.1% like the decade 1969-78, or instead the 9.8% result of the prior decade, or instead the glorious 19.5% per year result of one decade earlier (1949-58), or instead results like one of these periods:***

1967-76:	6.6%
1965-74:	1.2%
1958-67:	12.6%
1954-63:	15.7%

---

*See Federal Reserve Bulletins, Financial and Business Statistics--Mortgage Markets, for the years in question.

**Fixed-income returns are close to mortgage returns, notwithstanding constant fluctuations which find mortgage yields sometimes higher and sometimes lower. We have no total return data on mortgages or mortgage instruments, although starting this year, we do have a total return performance index on mortgage pass-through securities. See Salomon Bros., "Introducing the Total Rate-of-Return Index for Mortgage Pass Through Securities" (March 15, 1979) and their periodic subsequent data releases.

***The full data are set forth as Table 2 at the end of this paper. They are made available by the special cooperation of Frank Russell Co. Inc. These are the underlying data for Exhibit A-1 in that firm's splendid "Performance Charts & Statistics: Capital Market History and An Approach to Asset Allocation" (July 1979). Following Table 2 is that chart itself, reproduced with special permission of Frank Russell Co. Inc., Copyright 1979 by the Frank Russell Co. Inc. That firm's aid is greatly appreciated.

Indeed, of the 70 different 10-year periods from 1900 down through 1978, stocks outperformed fixed-income investments (using as a proxy the S. & P. High-Grade Corporate Bond Index) in 58 periods and underperformed in only 12. Seven of the 12 periods in which stocks underperformed were the Great Depression. But three of the remaining five poor periods were 1965-74, 1968-77, and 1969-78, and that recent experience is all some people think of.

Are those who would choose divergent investing over traditional prudent investing so determined to abide by the Law of the Austro-Hungarian Generals, is their hindsight so hampered by blinders, that they look exclusively at the immediate past and ignore the rest of our experience?

Are people who are so ready to abandon traditional prudent investing so sure of what the future holds that they assume inflation will vanish, or assume that prudently chosen equities will lose their superiority as an investment defense against inflation? From 1900-1978, the inflation-adjusted annualized 10-year rate of return on stocks has been 6.0%, but only 1.3% on fixed-income investments (again using the S. & P. indexes noted above).*

In short, advocacy of divergent investing would have less force if facts about traditional prudent investing were not used "selectively".

One other error compounding the smugness of hindsight about how prudent investing has performed, is that relative riskiness is ignored. If a total portfolio's return has been, say, 6%, that is thought to justify loans to, say, small firms at about that same interest rate. Only a moment is needed for a disinterested observer to see that unless riskier investments earn higher yields to compensate for the greater risk taken and to help build a cushion against the higher number of disappointments bound to occur in that higher-risk area, the whole fund itself soon will be an acute disappointment. When Will Rogers said that he was not as concerned about return on investment as about return of investment (a maxim that ought to be a legally required legend, in large type, on every page of every investment manager's merchandising materials), Old Will didn't mean what the advocates mean.

One final force fuels the advocacy of divergent investing. There are always people who need something to advocate, either

---

*Chart 2, reproduced from Frank Russell "Performance Charts", supra, with the same special permission.

because they are in the political arena, or want to sound off.*
I don't fault such people. Political dialog should be wide open; and far be it from me, as a law professor, to be so graceless as to condemn others for seeking a podium. But not all divergent investing advocates are blameless: some of them are hypocrites, urging that other people's funds be exploited in ways they wouldn't dream of allowing for their own. I regret that the outstanding example of such hypocrisy involves the secretary-treasurer of a union, since I am pro-union and consider the Amalgamated Clothing and Textile Workers one of the truly finest in many ways, today as well as historically. But how can we ignore the following contrast between advocacy and practice?

Here is the advocacy:**

> There are billions of dollars in the State Employees' Pension Fund. Clearly these monies can be invested in any number of ways to secure an adequate rate of return. The best interests of the system's beneficiaries, however, extend far beyond the mere rate of return.
>
> Investment capital provides the necessary dollars for economic growth and development. The range of opportunities to deploy capital is broad, and the billions of dollars in the New York State Fund can have tremendous impact wherever those dollars are directed. We need to seriously consider these directions.
>
> Profitablility cannot be the only criterion. Where are these investment dollars re-invested after they leave our hands? How much of the property on which the Fund holds mortgages lies within New York State? How many of the corporations whose notes or stocks we hold conduct most of their business inside of New York? Each dollar invested in an enterprise outside of this State diminishes our efforts to create jobs and economic growth right here.

---

*Some people argue that much of the advocacy has yet another source, a desire to reduce or abandon the impact of free markets in our economy. I note this because it is my assignment to set forth arguments others make, even if I reject such arguments. I reject this one because I do not know whether it is accurate, and further, because I do not belong to that part of the political spectrum which finds that labelling an idea as socialistic is _per se_ condemnation.

**Testimony of Jacob Sheinkman before New York State Assembly Committee on Governmental Employees, Hearings on Public Employee Pension Fund Investment Practices, New York City, Sept. 12, 1979, at pp. 3-4. For answers to his questions, see p. 28 below.

> We should demand to know why our pension fund invests in an office building in Washington, D.C., or a military base [?] in Kansas. The same rate of return can be found in numerous other investments without the same ultimate economic cost to our State.

And here is the investment practice of that advocate's union pension fund, with assets of $237 million: Of that $237 million, $4 million is in mortgages, $5 million is in insurance company guaranteed contracts, a tiny $800,000 is short-term, and the remainder has been invested--for so long that memory runneth not to the contrary--100% in U.S. Government securities, with five to 10-year maturities. (As one major trust department officer said, even more surprised by those maturities than by that portfolio concentration, "They're right-wingers, they don't even trust the Government!") Within recent months, that fund decided it should more fully utilize the "broad range of opportunities to deploy capital", so it started modest acquisitions of GNMAs! Now even if that portfolio satifies ERISA requirements of prudent diversification (and I am certain it does not, even though no court might be willing to hold trustees liable for investing exclusively in U.S. Government securities), surely anyone involved with such a portfolio ought not advocate that other people's retirement security be jeopardized by indulgence in divergent investing. Never have I seen so literal an example of great distance between where the money is, and where the mouth is.*

IV. The Prime Objection to Divergent Investing

Enough on why we face and must meet the advocacy of divergent investing. The prime objection to divergent investing is that any interference with pension funds' maximizing investment returns (at acceptable levels of risk) undeniably interferes with retirement security. Protection of retirement security is itself so socially responsible a goal that it is not only agreed to by ever-increasing numbers of employers and employees, but is underwritten by favorable tax treatment for contributions into pension funds, for the funds'

---

*See also Les Stern, Union Talk is Different From Investment Actions [the Machinists], Pensions & Investments, June 18, 1979, p. 39.

Some readers, wholly agreeing with my evaluation of this advocacy but troubled by such strong language as "hypocrisy" (or, for other conduct by other people described later in the paper, "propaganda") fear my blunt words may be less persuasive than others might be. Certainly I wish to persuade, but I also believe there is both room and need for direct comment.

I admit to forceful language. I choose it because I feel strongly about protecting retirees' security, and about how loosely some people talk about <u>other</u> people's money. I intend no offense to the people whose advocacy I attack.

earnings, and even for the benefits paid out. Nor is this one of those tax subsidies which is mainly loophole: for four decades the Internal Revenue Code required that pension funds be used for the "exclusive benefit" of participants' retirement security. The commitment to retirement security as the "exclusive benefit" was repeated in the Taft-Hartley Act in 1947, and in 1974 greatly reinforced for all private pension funds because some companies like Georgia-Pacific and Genesco had made divergent, self-serving (and illegal under the securities laws) uses of their pension assets. So ERISA came into law with its panoply of bans against divergent uses of pension funds. Could it be any clearer that Congress deems retirement security, in its legislative litany, the "exclusive benefit"?

The insistence on "exclusive benefit" is explained by the same reason that pension assets look so huge: the cost of retirement security. State and local pension funds, with a huge-looking $150 billion of assets, have an unfunded liability so vast--and involving such uncertainties and data gaps--that recent estimates range from a low of $150 billion to a high of $270 billion, as of 1975.* The current $150 billion of assets is so inadequate that a recent GAO study of representative state and local funds, including such strong ones as California state funds, found 3/4 of those funds so severely underfunded that they were not even up to ERISA minima for private plans.** As for the liabilities of private pension plans, my favorite indicator of the dangers of such data comes from dizzying disclosure by Monsanto. In their 1978 annual report, they highlight that their "unfunded present value of accrued benefits" is $27.8 million, down from $66.9 million at end-1977. Then deep in a footnote they disclose that those figures differ from the much larger figure for unfunded prior service costs, required by SEC Form 10-K, a mere

---

*House Committee on Education & Labor, Pension Task Force Report on Public Employee Retirement Systems (March 1978), at 165. Even the lower figure approximately equaled the total outstanding credit market debt of state and local governments in 1975.

**GAO, Funding of State & Local Pension Plans: A National Problem (Aug. 30, 1979).

Some argue that state and local funds should not be measured against ERISA funding minima, because the continued flow of tax revenues is far more sure than the continued flow of corporate earnings. Putting wholly aside what if any legal requirements should pertain to state and local systems' funding, three facts seem clear. Low funding now means so much more burden later. Second, the unbroken record of continued flow of state tax revenues seems likely to continue, but the municipal record has been different and may well become worse. Last, even though tax revenues may continue to flow, their amount seems unlikely to enjoy continued expansion, while the variety of state and local needs remains large and pressing.

$384.1 as of end-1978 with the 1977 figure undisclosed. Still a third much smaller figure is also reported in the annual report, for unfunded vested benefits--repeated, without cross-reference, 17 pages later. (At least Monsanto does disclose the various figures. GM, like most companies, does not burden its stockholders with the larger figure, unfunded liability for prior service costs, $8.0 billion according to their 1978 10-K. Instead they stop in their 1978 annual report with the more manageable-looking $3.9 billion liability for unfunded value of vested benefits. Such disclosure satisfies present legal and accounting requirements. Until accountants and the SEC bring pension disclosure up-to-date and make it readily usable for comparative purposes, great caution is needed in use of pension liability data.*)

To build the assets needed to meet such fearsome liabilities, costs have been high, much higher in the 1970's than the 1960's and substantially higher in the late 1970's than in the early 1970's. The best measure of pension costs (i.e., the sponsor's current contributions to its pension fund, actuarially calculated to meet future liabilities) is percentage of payroll.** According to our largest and longest survey, private pension costs _as a percentage of payroll_ in 1977 and 1978 were up 14% from 1971-73, and

---

*An outstanding brief guide to the "nine different kinds of measures being used to determine whether a company has a pension problem" is Barnet N. Berin, Unfunded Pension Liabilities and Pension Cost (Wm. M. Mercer Inc., 1979).

**Berin, _supra_, at 3-5.
For measures other than percentage of payroll, to be used with even more caution than the payroll figures, the following are from COMPUSTAT data on the 224 companies which made complete pension disclosure for all years from 1973 to 1978: Aggregate unfunded vested liabilities increased 133% from 1973 to 1978--compared to a 48% increase in aggregate shareholders' equity in those firms--despite a 140% rise in aggregate pension costs. Pension costs as a percentage of pretax income plus pension costs, increased as follows:

1973:	13.61%	1976:	19.89%
1974:	14.93%	1977:	21.16%
1975:	20.25%	1978:	19.48%

The 1977 figure is distorted by Bethlehem Steel's hugh loss. Oppenheimer & Co. (Norman Weinger), Pension Costs and Liabilities IV, Sept. 4, 1979.

up 36% from the average for the 1960s.* They now run over 6% of payroll for diverse companies,** and over 7% for large companies.***

Private pension costs, high as they are, have already passed the time of sharpest increase to meet the ERISA minimal funding requirements. But state and local plans are not as far along toward correcting the dangerous era of "pay-after-you-go" and increasing their assets to levels adequate for their liabilities. At present, we have only the sketchiest data on state and local plans as a group: 16% of payroll for larger state and local defined benefit plans, 18% for smaller ones, as of 1975-6.**** We have no other survey of state plans but have impressively thorough data from 1970-77 on hundreds of cities.***** Going by 1977 data on 972 cities, police and fire pension costs are running 13.53% of pay for hours worked, and general employees' pension costs are running 9.64%, neither figure including Social Security contributions. Adjusting the Chamber of Commerce private-sector data noted above for comparability--and remembering that all private

---

*U.S. Chamber of Commerce, Employee Benefits 1978 and earlier years.

Data on median annual growth rate of pension costs of the 40 largest U.S. industrials:

1969:	7.0	1973:	14.5	1977:	8.5%
1970:	10.5	1974:	19.5	1978:	14.0%
1971:	14.0	1975:	14.7		
1972:	12.0	1976:	20.5		

Regan, The 1976 BEA Pension Survey, table 2, p. 6; and Regan, Is the Pension Burden for American Industry Growing? Financial Analysts Journal, Sept./Oct. 1979, p. 6.

**U.S. Chamber of Commerce, supra.

***Johnson & Higgins, 1979 Report on Funding Costs and Liabilities of Large Corporate Pension Plans (survey of 475 of the Fortune 500 industrials, and 173 of the non-industrial "Fortune 50's"); and Regan, supra (survey of 40 major industrials).

Some companies report percentage of total payroll, some report percentage of "covered" payroll--the figure applicable to participants in the plan. And some companies include all employee benefits and social security taxes in the base. See Regan, supra.

A recent survey of 79 of the Fortune 100 industrials, using newly disclosed data from 1979 proxy statements, reported an average pension contribution of 11.2% of covered pay. Towers, Perrin, Foster & Crosby, The Top 100 Companies: Pension Contributions for 1978 (October 1979).

It is worth noting that pension costs are less susceptible to reduction than payroll costs, since so much of the pension contributions is required to meet unfunded vested liabilities.

****U.S. House Pension Task Force Report on Public Employee Retirement Systems (March 1978), at 136.

(*****See next page)

systems are in addition to Social Security, while some state and local systems stand alone--the cities' percentage of pay for general employees is about 30% above the private pension costs, and for police and fire, about 80% above private pension costs.

Though state and local costs have their main increase still ahead of them, consider how large a bite of state and local taxes already goes into funding employees' pensions, and how fast that bite has grown:

Year	Per capita state & local taxes paid	Per capita, among all state and local tax-payers, contribution paid for state & local pensions	Percentage of per capita state & local taxes, for pensions
1956/57	$169.56	$12.26	7.23%
1966/67	$308.19	$25.24	8.19%
1976/77	$813.01	$81.37	10.01%

Source: U.S. Census, Census of Governments 1957, Vol. IV, No. 1, Employee Retirement Systems of State and Local Governments ; U.S. Census, Summary of Government Finances 1967, 1976. U.S. Social Security Administration, Division of Retirement and Survivors Studies Office of Retirement Security, Retirement and State Finances, 1975. The figure for pension contributions includes both the employer contributions and the employee contributions. State and local employees contribute about 20% of their system's in-flows (Tax Foundation survey, November 1979), while private employees' contributions are only about 3% (Chamber of Commerce, Employee Benefits 1978).

(Footnote for p. 134:)

*****Labor-Management Relations Service of U.S. Conference of Mayors and E.H. Friend & Co., National Surveys of Employee Benefits for Full-Time Personnel of U.S. Municipalities, 1979 and three earlier surveys. Officials of E.H. Friend and company made special efforts to furnish data not printed in the reports, and their aid is greatly appreciated.

It seems odd indeed that there are no comparable data on the state systems, which of course have far vaster resources than the municipal systems and surely no less sophistication. Hopefully this gap will close soon, especially since it should be easy to come up with valuable data on the state systems in light of the experience developed in the municipal surveys.

EBRI's "Research Agenda," now in draft, comments pointedly on the data problems:

(Footnote continued on next page)

This rise in pension costs, doubling from 1957-67 and more than tripling from 1967-77, outstripped the sharp increase in state and local taxes. This rise even outstripped the increase in private sector pension costs,* although of course all private employers were also increasing Social Security while some states and localities are not covered.

These state and local costs are almost entirely unavoidable. As the state and local government work force has expanded, and as the age distribution of that work force and of the nation generally has shifted toward greater "maturity", a cost rise has been inevitable. Indeed, over the next few years, because pension costs are sharpening their rise but state and local taxes may well plateau or rise only slowly, the pension bite will loom ever larger.

Such huge costs are justified most meaningfully not by numbers about an abstraction, "unfunded liabilities", but by pointing directly to retirement benefits being paid. Lacking good national data,** and also to make the point more concretely, let us focus upon one strong Western state (not California) system's effort to keep its retirees from being killed--all too close to literally--by inflation.

(Footnote to page 134, continued)

> In summary, analysis of public employee plans is limited by insufficient and non-uniform data collection.... And, the differences in data that are available do not allow uniform comparisons of public plans, private plans, and Social Security.

*Comparable data were obtained by dividing total private employer contributions to pension plans, by our total population. The per capita private pension contribution in 1957 was $23.64; in 1967 it was $45.74; and in 1975 (the latest year available) it was $126.75.

**Our lack of basic information about the pension scene is one of the most negative commentaries about the Labor Department and IRS, even five years after ERISA. Whatever else government should or shouldn't do, it should improve market efficiency and the soundness of government decisions by helping us know where we are.

Here again, EBRI's pending "Research Agenda" report is to the point:

> "Research to date on the impact of inflation on retirement income has been fragmentary and inconclusive."

Even our knowledge about major corporate plans is limited to fragments like these:

Of 94 major companies, 65 of them in the Fortune 100 top industrials: (1) only 3 have any COLAs; (2) almost 1/2 gave no

(Footnote continued on next page)

That system has raised benefits every year, even by double-digit amounts in several years, even for retirees in pay status. Yet a person who retired in 1967, whose state pension benefits have more than doubled--a rise of 115%--has despite even that rise suffered a loss in purchasing power. That 1967 retiree has seen his 1967 dollar drop, by September 1979, to 46 cents. Thus even as much as 115% more than he was getting in 1967, gives him about 99 cents, just staying even at best.

Of course benefits would not be allowed to slide behind inflation were it not for the extraordinary cost of keeping up: Earlier I noted the magnitude of GM's unfunded liabilities. Their pension cost as a percentage of payroll in 1978 was 7.7%, a little above median for large firms.* Their 1979 wage settlement almost collapsed over pension improvements, but the final agreement, which includes a 39% benefit improvement for pre-1970 retirees, will raise GM's pension costs roughly 50% according to the company.**

If the day comes that retirees are well off, relative to the rest of our society, then we can re-open the question whether the "exclusive benefit" of retirement security can be relaxed for alternative goals. Until that day, pension assets are needed for a social task even bigger than these assets: paying retirement benefits and improving their amount. And until that day, advocacy of divergent investing is an unconscious--or, if conscious, a contemptible--effort to take money from the elderly, who themselves need financial aid as much or more than any other group. It would be entirely different

---

(Footnote to p. 136, continued)

inflation increase to retirees in 1977 or 1978; (3) the median period between ad hoc increases was about three years; and (4) as to the adequacy of the increases in keeping retirees level with inflation: "It was not possible to determine the average level of benefit increase.... As a general rule, however, ad hoc increases rarely (if ever) exceed the rate of inflation since retirement." Towers, Perrin, Forster & Crosby, Pension Increases for Retired Employees (July 1979).

As for state and local systems, while many do have COLAs, all but three systems have had "caps" limiting cost-of-living increases to 3% or 4% or less per year, and the three exceptions have all recently been revised--downward.

Surely one of the most valuable contributions the President's Commission on Pension Policy could make, would be to advance the basic data without which all our answers are too close to being stabs in the dark.

*Regan, supra. As a percentage of "covered" payroll GM's cost is of course larger, and somewhat more above average, 13.8% in 1978 compared to the average 11.2%. Towers, Perrin, Foster & Crosby, The Top 100 Companies: Pension Contributions for 1978 (Oct. 1979).

**Business Week, Oct. 1, 1979, p. 93; BNA Pension Reporter, Dec. 24, 1979, A-3.

if the divergent goal being advocated were aid for the elderly less fortunate than those who have at least some pension. But the blunt truth is that divergent investing turns completely away from retirement security.*

---

*Throughout this paper, my analysis rests on the fact that if pension investment returns deteriorate, "everyone, all the major parties bear the risk", as it was put succinctly by one participant at the December 6 forum (George Lingua, Senior Vice President, Citibank Investment Management Group). This applies to all types of plans except defined contribution, where only the beneficiaries bear the risk and where there is no dispute about whether they should be free to decide what risks they choose.

In the largest category of plans, private defined benefit, the sponsors are not liable--in the present state of the law--to honor the full pension promise, not even full vested benefits but only "guaranteed" benefits, and even then only to the extent of 30% of the corporations' net worth. Therefore, if investment returns are poor and the pension plan itself cannot honor vested liabilities, the beneficiary loses. In some private plans, like the major steel companies', the sponsor accepts complete liability, so that the situation there seems closer--in these regards--to the state and local scene.)

In state and local plans, presumably the beneficiary will not lose unless the sponsoring government goes into bankruptcy, but of course even before that payments may be suspended, and retirees need cash, not strong legal claims.

All sponsors of defined benefit pension plans lose from weak investment performance because they must pro tanto increase their contributions to keep the plan actuarially sound. This hurts corporate earnings, or the tax bills.

And all beneficiaries of defined benefit plans lose even if their existing pension promise is met, for two reasons: For most participants, benefits are barely adequate if that, and improvement is necessary if feasible. Further, in an inflationary era, if there is no improvement then in fact not even the original pension promise is being honored.

"To the extent the pension capital is not maximizing earnings . . . this would be to the detriment of participants in the pension plan since the employer's ability to provide benefit improvements, or even to continue contribution to the existing plan would be jeopardized." Statement of Richard O'Brien of General Motors on behalf of the ERISA Industry Committee (ERIC) before President's Commission on Pension Policy, Dec. 10, 1979, at p. 3.

This is as true in state and local systems as in the private ones. "Public employees will be the patsies blamed for high pension costs", notes Victor Gotbaum, New York City public employees leader. BNA Pension Reporter, Dec. 18, 1978, p. A-9.

V. The Limits of "Moderate" Divergent Investing

What of the moderate advocates of divergent investing, who want to pursue additional goals so long as retirement security is not impaired? As noted at the opening of this paper, what I call "XX investing" is so obviously desirable that it must suffer some flaw or it would sweep the field on its own. Some XX investing is in place. Colorado and Alabama are typical of many state pension funds in such explicit provisions and practices as these: "Preference will be given to Colorado investments, all other things being equal".* Alabama, where "in no instance are quality or interest rate standards to be reduced just to invest in the State",** has in the state pension portfolios $199 million in in-state mortgages and $75 million "in private placements to Alabama corporations such as First National of Mobile, Merchants of Mobile, Central Bank, PPG and International Paper."***

The New York State Common Retirement Fund's $11.8 billion portfolio includes equity holdings in 228 corporations.

- --49 of the 228 are headquartered in New York.
- --87 have manufacturing operations in New York.
- --28 have retail or other sales facilities in New York.

And 31% of the Fund's FHA mortgages are on New York property.**** Of course the smaller the State, the harder it is to accomplish such XX investing. As one small-State pension investment officer put it, "the only thing worse than investing out-of-state is investing in-state and turning out wrong."

Nor are "local" investments clearly in the interests of even a "local" pension plan's participants. The New York City plans send over 10% of their benefit payments to retirees in just Florida, let alone the total portion that is sent out of the New York City area. Hypotheticals about other-worldly situations where all actives and all retirees are benefited by a "local" investment are all too likely either academic or simple deception.

---

*PERA Statistical Supplement-1977, p. 14.

**General Investment Policies of ERS and TRS; see also Ret. Systems Annual Report 1978, p. 7.

***Pensions & Investments, Oct. 22, 1979, p. 6.

****Statement by Comptroller Edward V. Regan before N.Y. State Assembly Committee on Public Employees, Sept. 12, 1979.

There may be enough XX-type investments for a moderate number of small portfolios, but there are not enough to matter significantly. Notice, e.g., that the Dreyfus mutual fund complex, one of the nation's largest, does have one fund pursuing alternative investing -- a small fund which has stayed small. Or, notice that the recently bally-hooed Drexel, Burnham divergent investing for two Taft-Hartley pension funds involves only small portions of those portfolios, totalling only $5.5 million in pension assets (and $9 million from one union's own reserves). Notice that the few portfolios which have acceded to the demand to divest and avoid stocks in companies involved in South Africa, have been endowment portfolios which may look big to the students, but which are small compared to pension funds, let alone in comparison with the markets and corporations in question.

A few small portfolios' "ethical" investing may be morally satisfying (or politically helpful) to the persons involved*; but for actual impacts on corporate conduct, substantial investment patterns are a <u>sine qua non</u>. And since big portfolios diversify holdings so that almost none hold even 5% of a company's stock,** even the portfolios that matter are not likely enough to have holdings that matter. Do you believe that Exxon or GM or Citibank will alter their carefully considered conduct because Harvard*** or

---

*"[President's Commission on Pension Policy] chairman C. Peter McColough asked how that strategy would improve life if the securities would be purchased by someone else. Ms. Mares responded that a clean conscience might indeed be the only improvement." <u>Pensions & Investments</u>, July 2, 1979, p. 8.

The Washington Post's insightful columnist William Raspberry has noted that not even the clean conscience is deserved, since the "ethical" investor is merely "selling your frills to your sister." <u>Post</u>, May 16, 1979, Op-Ed page.

**The sole exception is the Morgan Guaranty trust department, now isolated in its ostrich-like insistence on holding more than 5% of the stock in each of more than over 185 companies, including such majors as AMF, AMP, Avon, Allied Stores, Armstrong Cork, Associated Dry Goods, Baxter Travenol, Deere, Digital Equipment, Disney, International Paper, K Mart, Louisiana Land, Motorola, Pittston, Polaroid, Squibb, Texas Instrument, UAL, United Technologies, <u>et al</u> <u>et al</u>. Report of the Trust and Investment Division 1978, <u>at 35-43</u> (list of holdings of $10 million to $1,552 million, each.)

Even if the Morgan's portfolio companies might listen to it, the Morgan is not likely to pursue divergent goals.

***Harvard will not jeopardize its own important social responsibility for the ephemeral enthusiasms of student advocates. For probably the finest explanation of why an institution that tries to pursue all of society's goals will advance none of them, see President Derek Bok's "Open letters to the Harvard Community", Reflections on the Ethical Responsibilities of the University in Society (March 9, 1979) and Reflections on Divestment of Stock (April 6, 1979).

the New Jersey state fund or GE sells $25 or even $75 million of their stock? Even less likely will little funds' actions matter. (However, any stockholder may be able to make a difference through the highly visible stockholder proposal route, noted more fully below as a more effective alternative to divergent investing.)

Odd as it may seem, even a large fund's concentrated investment may lack discernible impact. Oregon's state pension funds have about one-third of their fixed-income assets in in-state mortgages. (The portfolio of $1.315 billion is limited to 35% in equities, and has about 65% in fixed-income investments.) While no analysis has been made, well-informed authorities doubt that mortgage rates in Oregon are any lower than they would have been without such pension investment. It is definite that in the current crunch on mortgage lending, that fund, already holding such a substantial mortgage position, has not been providing new mortgage funds. It is also clear that the pension fund's mortgage program, which operates at market rates, pales as a means to promote housing when compared with that State's program for "veterans": well over $1 billion is outstanding, and a few hundred million more now flowing, to "Oregon's veterans", at current rates of 5 3/4% up to an $80,000 loan, 6% up to a $140,000 loan. Can any pension fund be looked to for real action like that?

One other obstacle stands in the way of the desirable but Utopian XX investing: if the pursuit of divergent goals goes beyond modest steps that lack any or any discernible impact, then investment strategy will have to alter, at the almost certain expense of lower investment returns and impairment of retirement security. Again Wisconsin gives us the most illuminating experience, though this time it involves the University endowment fund.

To implement the University's decision to divest and avoid all firms involved in South Africa, "about half of the equity portfolio--$9 million to $10 million" --had to be sold.* "The new universe of stocks and hence the portfolio itself is small-company oriented", according to John Windsor, President of Heritage Invest-

---

*One of the arguments often made against divergent investing involves the transaction costs of divestment. The most recent estimate of such costs, for Harvard, was that brokerage fees alone might range from $5.7 to $16.5 million. Bok, _supra_, letter on Divestment of Stock, p.5. "Stanford, Yale, and Princeton have indicated that one-time transaction costs would range from $1.4 million to $6.2 million for portfolios approximately one third the size of Harvard's." _Ibid_. Remember that only a portion of any endowment is in equities.

Because I deem it a clear breach of fiduciary duty to sell too quickly, and because I think the real issues involve future investment strategy rather than the costs of transition, I do not rely on transaction costs as an implementation problem, although they clearly are such for any portfolio forced into immediate steps to perfect the world by close of business Friday.

ment Advisors in Milwaukee, which manages the University's account. "You lose every significant multinational company." The portfolio, which under a prior manager had been invested 70% in equities and now is at 45%, would have been brought down by the new manager to about 60% equities but for the divergent goal's intrusion. The special reduction was made "until some of Mr. Windsor's concerns are cleared up." "We are unsure of the long-term penalties, and won't know for four or five years."*

VI. The Problems of Implementing Divergent Investing

In addition to all the other objections to divergent investing--both in its moderate, XX version or in full-blown readiness to impair retirement security in order to further other goals--there are seven acute problems of implementation:

Implementation problem (1)--which divergent goals shall be pursued? Consider:

(a) Equal employment opportunity
--in terms of race, sex, age, et al.

(b) Occupational safety and health

(c) Consumer protection
--product safety, fair advertising, etc.

(d) Unionization

(e) Environmental protection

(f) Energy conservation

(g) Discouraging involvement in countries violating human rights
--South Africa
--what about all the others?

(h) Inner-city redevelopment

(i) Housing generally

---

*Pensions and Investments, So. African Stock is Dumped, But No Ill Effects Yet: Heritage (Nov. 5, 1979), p. 6.

Mr. Windsor was present at the EBRI discussion on December 6, and the reader is urged to turn to the transcript for his full and fascinating comments.

For a theoretical evaluation, see Andrew Rudd, Divestment of South African Equities: How Risky?, J. Portf. Mgt., Spring 1979, p. 5. That analysis did not consider the portfolio size. In recent testimony, the author "heavily qualified" his conclusion because "important procedural, legal and economic implications have not been examined." BNA Pension Reporter, Dec. 17, 1979, p. A-19.

(j) Small business generally

(k) Local or regional development

Then there are the goals that evidently don't interest today's advocates of divergent pension investing:

(l) discouraging production of alcohol and tobacco

(m) discouraging production of war material (This little goal, which stirred such activity against Dow Chemical only a few years ago, seems forgotten.* No military draft, no pacifist passion? No recognition that the wealth devoted to retirement security is modest compared to military costs? No recollection of Eisenhower's valedictory warning about the military-industrial complex, so that only the industrial seems a worthy target? Perhaps the Undershafts of today enjoy such peace instead of the protest of other days because if their product realizes its purpose, all our lesser problems will be solved?

> I cry against these arts
> That slay what we create.)

And then come the goals that would emerge as soon as divergent investing would take hold. An example we all should have thought of but probably didn't, emerges from a survey of corporate pension investment professionals, conducted last Spring by Institutional Investor magazine. After asking whether the respondents had engaged in "socially responsible" investing or had experienced pressure for it--none were so engaged--the survey asked what "social" goals the respondents would follow if they diverged from traditional prudent investing. The response: the corporate pension funds' way-out-ahead top priority would be "setting limits on how much your fund should invest in companies or industries in competition with your own company."**

Implementation problem (2)--What priorities shall rank the divergent goals, if more than one is to be pursued? This is not merely a matter of the finitude of resources, meaning the pension fund can no more pursue all the goals than the child in the candy

---

*Fortunately not wholly forgotten, even if almost so. See shareholder proposals listed in Interfaith Center on Corporate Responsibility, Corporate Examiner for 1979.

**Institutional Investor, How Pension Officers View Social Responsibility (Apr. 1979), p. 85. Boeing, for example, restricts its pension investment managers from any equity holdings in aerospace industry stocks. Business Week, Nov. 26, 1979, p. 100.

shop can buy all the goodies. Worse, what happens if a pension system decides it wants both to promote equal employment opportunity and also to discourage involvement in South Africa; and finds that a firm at the forefront of equal employment hiring, promoting well up the ladder, etc., is also involved in South Africa? The California State and Consumer Services Agency has commissioned the Council on Economic Priorities to evaluate firms in light of just those two criteria.* It will be interesting to see how that able group reports on firms like BankAmerica.

Implementation problem (3)--Who decides what shall be the goals and priorities? By now it must be obvious that the sole goal on which all pension plan participants will agree, is protection of retirement security. Any divergence involves the participants and their trustees in a process of decision which will be political at best or subjective and divisive at worst. John Petersen has put it most pointedly: "One man's 'socially useful' investment is another man's 'do-gooder boondoggle'."** In any event the decisions are likely to be unacceptable unless they result from a truly political process, i.e., a representative and accountable group making the decisions.*** Simple and uncontroversial as it may seem to install such a process, there are two considerable problems.

---

*The Council is noted more fully below, at p. 149. The report in question will cost $58,100, and is due quite soon.

**Speech at the Municipal Finance Officers Ass'n. Annual Convention, Detroit, June 6, 1979.

***In Sacramento, Calif., three unions of city employees and an organization of retired city employees recently wrote the City Retirement System ($100 million in assets), which is considering a proposal to divest all stock in South Africa-involved firms. The four groups noted their "strong objection to the practice of 'social' investment, in any form."

> "No man can serve two masters. It is impossible for one in a fiduciary relationship to serve his own philosophical interests and properly discharge the duties of his trust.
>
> "Moreover, true social justice would require the awkward and unacceptable system of polling all curent and retired city employes in the matter of each investment in order to determine whose social and political interests are to be served."

(Pensions and Investments, Nov. 5, 1979, p. 1.)

While "polling . . . in the matter of each investment" seems the absurd extreme, the thrust is correct: once the pension board is to choose among competing goals and decide which may deserve subsidy at the expense of others, then the board must be as accountable as a legislature which decides to tax some interests for the benefit of others.

I have long argued for representation of employees and separately of retirees, in pension plan governance.* Only in state and local pension systems, especially police, fire and teachers' funds, is such representation quite frequent.** But even in the majority of state and locals with employee representation, there is none for retirees. The difference between actives and retirees becomes a conflict of interest as the assets are exploited for goals other than retirement security.

The leading example is New York City. While it was necessary and therefore proper to use the five New York City pension funds as a temporary bridge to get the City through its financial crisis, the deplorable fact is that the funds are being put at risk to render long-term aid that only a captive source would render.*** This

---

*See my testimony in Hearings on PERISA of 1975, House Committee on Education & Labor, Subcommittee on Labor Standards, 94th Cong. 1st Sess., 1975, pp. 115, 125; in Hearings on Teamsters' Central States Pension Fund and General ERISA Enforcement, Ways and Means Subcommittee on Oversight, 95th Cong. 1st Sess., March 14-15, 1977, pp. 418, 424-5; in Hearings on New York City Pension Plan Investments, Senate Committee on Finance, Subcommittee on Private Pension Plans and Employee Fringe Benefits, 95th Cong. 2d Sess., March 7-8, 1978, pp. 93, 111, 122-3; in Hearings on PERISA of 1978, House Committee on Education and Labor, Subcommittee on Labor Standards, 95th Cong. 2d Sess., Nov. 15, 1978, pp. 121, 127; and in Hearings on Pension Plan Management and Beneficiary Participation, Senate Judiciary Committee, Subcommittee on Citizens and Shareholders Rights and Remedies, 95th Cong. 2d Sess., Nov. 21-2, 1978, at pp. 4, 12.

See also my Conclusions and Recommendations of the Steering Committee, Twentieth Century Fund Report on Conflicts of Interest in Securities Markets (forthcoming March 1980).

**For data on board composition, see U.S. House Pension Task Force Report on Public Employee Retirement Systems, 95th Cong. 2d Sess. (1978), pp. 206-7.

***That there has been no loss yet by no means suggests there will not be over the next 17 years, the period to which the funds hae been committed so unsoundly. Even were there no loss at all, the imprudence is patent. When the commitment began, one pension professional wrote, deploring others' silent acceptance of the erosion of trusteeship: "Had trustees used such funds to play roulette in Las Vegas, the act would be considered a violation of their obligations even if they had won. . . . [But even if the City funds do "win",] a great many beneficiaries have long since retired . . . . Who speaks for these people?" Robert S. Waill, Trustees: A New and Dangerous Role, N.Y. Times, Nov. 2, 1975.

has been done largely to protect current job security and pay, thereby favoring the actives although the several billion dollars of assets so gambled may well turn sour and cause untold harm to retirees. Certainly all recent analyses coming out of New York sound grim for long-term holders, which is what the retirees have become. Who committed them to that risk? Take the Policemen's Fund as the most striking example:* its board's votes are divided equally between city officials and appointees on one side, and on the other, representatives of the participants. Who are those representatives? Representating the patrolmen, three officers of the Patrolmen's Benevolent Association. For the sergeants, one representative. For the lieutenants, one representative. For the captains, one representative. For the detectives, one representative. And for the retired members of The Finest, no representative at all. As of 1978, the Police Retirement System had 25,911 actives and 18,212 retirees.**

I submit it is intolerable for a fund to diverge from the exclusive benefit of retirement security without any retiree role in the decision about such divergence. In Taft-Hartley funds, by statutory requirement the employees have as many representatives as the employers--but retirees have none. Retirees do not need separate pension board representation if they are entitled to vote, just like actives, for the union officials generally. But such democratic and fraternal treatment of the franchise is found in only a small minority of unions--e.g., Mine Workers (who of course have a major Taft-Hartley), and also the Auto Workers,

---

*The Teachers Retirement Board composition was recently described by the U.S. Court of Appeals for the Second Circuit: "The Board's seven members are trustees for the fund. Three are elected by active employees of the Board of Education [teachers, not all employees]. The concurrence of at least one of these three is necessary for any decision of the Board. Retired employees have no representative on the Board: Kirshner v. U.S. et al, No. 77-6104 (Nov. 30, 1978), cert. den. Dec. 1979.

The Teachers' Fund does have one or two retirees on its board, but they are not accountable to the retirees. They are selected by the teachers' union officers in whose selection retirees have zero voice. According to my information, these one or two trustees also chair the only union committees which carry substantial compensation for their chairs. Appointment to those chairs is by the union officers accountable only to actives.

**In fact, for these purposes actives who are near retirement are more like retirees than like other actives, between the high job security they enjoy because of their seniority, and their impending move into retirement.

Machinists and a very few others.* The Steelworkers, who are among the unfraternal great majority of unions, at their 1978 international convention voted down even a proposal to establish an advisory committee of retirees.**

As for corporate pension funds, I know of only one exception to the flat statement that employees, both active and retired, have no role at all in pension plan or fund governance. (The one exception is Citibank's pension plan for its own employees.) Such paternalism is perfectly appropriate at, say, U.S. Steel, where the company stands liable for their pension promises. But since the great majority of corporate pension sponsors insert a dubious provision that only the pension fund, not the employer, is liable for payment of the promised benefits, it seems clear that these disclaimers should be scrapped (as there are other good reasons to do) or the pension trustees must include representatives of both active and retired employees.

Even if appropriate representation is afforded to actives and retirees, one futher problem looms large. Representativeness by no means guarantees expertise, and it is hard indeed--I believe it a major problem, especially in Taft-Hartley and state and local funds--to assure that the trustees command adequate expertise even to select and oversee investment managers, let alone make financial decisions themselves. But if we add to their fiduciary responsibility as prudent investors, the burden of deciding how to promote regional or local or inner-city development, or how to resolve the question of beneficent involvement in South Africa versus withdrawal, etc., then I submit we will suffer amateur hour in the extreme, except that here, it is other people's money being played with. This problem of evaluating how to pursue divergent goals, even assuming there is adequate consensus on what those goals are and in what priority, brings us to the fourth implementation hurdle.

But note: does anyone doubt how participants would decide if it is up to them to choose between pursuing a smorgasbord of divergent goals which may impair investment returns, or on the other hand, trying to maximize investment returns so as to protect retirement security? Plans for participant input in selecting this or that divergent goal are only the facade of democracy if they do not assure a democratic decision on whether to diverge at all.

---

*See Dept. Labor, Labor-Management Services Admin., Union Status and Benefits of Retirees (July, 1973).

**Steel Labor No. 12, at 4 (December 1978). Though the steelworkers are less fraternal than some other major unions, they may be more democratic, since their national leadership is chosen not by convention but by open, nation-wide election.

Implementation problem (4)--The lack of information on which to base investment decisions aimed at furthering divergent goals, is severe. The fact that "There is no systematic method for obtaining and evaluating information about the activities and practices of companies in which the funds invest," is deemed the first of three respects in which "the current decision-making framework appears inadequate," from the perspective of one of the best studies advocating alternative investing.* Of course if the divergent goal is promoting local housing, it is easy enough to know whether a mortgage is local. Nor is identifying "local" corporations difficult. But it is when divergent investing goes beyond simple local chauvinism--a nostalgia perhaps for the medieval Italian or ancient Greek city-states, glorious eras but hard to mesh with steel mills and computers--that the real information difficulties arise.

Imagine for a moment how difficult would be straight-forward financial analysis if we had no Securities Act of 1933, and neither an SEC nor an accounting profession to work at assuring that financial data are complete and comparable. That horrible --I fear some souls would call it delightful--fantasy is the actual state of affairs in the realm of "social performance" information. That is, if a pension fund has decided it does want to pursue alternative investing in its equity portfolio, how does it select the companies to buy or to avoid?

The information difficulty --or problem of separating the good guys from the bad guys-- is no problem at all in a few instances. It is easy, I submit, to categorize J. P. Stevens: it is not merely their relations with a union or with the NLRB, it is that they have gone so far as to be held in contempt by Federal courts, and twice. I am willing to avoid investment in such a company on strictly non-financial grounds. Identification is easy, the conduct is extreme, the criterion is clear and very widely accepted --avoidance of egregious law-breakers-- and the cost of avoidance is nil: so many other investments comparable on financial grounds, are readily available.

But the J. P. Stevens-type situations are rare --fortunately so, we all would agree. What about the norm? How decide which company is a good equal opportunity employer or good on employee safety or health; or which is unfair in its advertising or a bad polluter; or good or bad on whatever may be the chosen criteria? Or, even if a consensus can be reached about our corporations' involvement with South Africa --that is, even if we can decide whether being "in" or being "out" is more socially beneficial-- what degree of involvement with South Africa is enough to matter?

---

*Coltman & Metzenbaum, "Investing in Ourselves", Massachusetts Social & Economic Opportunity Council Task Force on Public Pension Investments, June 1979, at p. 29.

The severe inadequacy of data on issues of "social performance" does not mean one cannot find out about GE's relations with the EEOC, or GM's with OSHA. But, can one make a decision about whether GE or GM are notably good, or notably bad, without having data on comparable firms? One would never make an investment decision on financial grounds without measuring the potential investment against comparable other ones. Without comparable data, investment decisions on non-financial grounds risk being both inaccurate (and, therefore, unfair*) and ineffective: Company A might look good or bad on, say, equal employment only as long as one doesn't know how others in its industry, or its geographic community, are performing. It is possible to pull such data together from public information available at the corporations and agencies. One "public interest" research group, the Council on Economic Priorities, performs such analyses, and their products enjoy credibility and widespread high regard. But producing responsible analyses in this area is a considerable task involving substantial costs: e.g., the CEP's study of political influence and lobbying by military contractors will cost $75,000; their study of nuclear power's impact on job creation (in one area!) cost $292,000; their much-praised study of paper companies' pollution practices cost $50,000 (and that was back in 1969-70).

In September, the pension community was offered help in identifying "target companies", i.e., bad "social performers" in which investment should be avoided. This foundation-funded** "social audit" of pension investing, done by Corporate Data Exchange, used four criteria:

---

*Consider this 1979 example involving a key "social performance" issue, redlining. A shareholder proposal presented to Allstate Insurance was withdrawn by the sponsors, Chicago religious groups, after discussions wth Allstate management. Allstate's vice president Robert W. Pike described the situation:

"We don't redline. We were cleared by the Illinois Insurance Commission just last week. We are the largest writer in the inner city, 15% in Chicago. Our competition can't come close. We presented to the groups Allstate's contribution to the city, its directives to its employees. They saw us doing what they wanted, and the resolution was withdrawn.

"The trouble is that people who do something for the neighborhoods are the targets for the redline critics. Why us? Why not look at the companies that are not there [in the inner city]?" From Purcell, Management and the "Ethical Investors," Harv. Bus. Rev., Sept.-Oct. 1979, at pp. 24, 30.

**Not entirely: grants came from three small foundations, the People's Business Commission, Teamster Local 70 (Oakland, Cal.) and two individuals.

The study's cost is not disclosed.

"predominantly non-unionized" firms, OSHA and EEOC violators, and major investors in or lenders to South Africa. Presumably CDE ignored other criteria for the simple, valid reason that its resources were finite. Surely an exemplary answer to some of the problem of identifying firms that are notably bad or good in "social" performance would be a key step toward overcoming the information problem.*

CDE's effort is a disservice to those who seek to use non-financial data in equity selection. In saying this I do not underestimate the difficulty of assembling such data. Others have criticized CDE for using 1976 data to base judgment and decisions in 1979. But anyone who has grappled with the problem of retrieving Form 5500's from the Department of Labor or with similar obstacles to data-gathering, let alone with the special difficulty of any new assemblage of data as distinct from continuous, routine reporting, will not fault CDE on such matters.

There are seven flaws in CDE's "social audit". Some of these indicate the product is propaganda rather than an "audit". At least one indicates that the product lacks integrity.

CDE examined data on 142 large private and state or local pension plans' holdings in 99 "target companies" as of 1976. The report divided the 142 plans into four categories. Three categories are familiar: state or local, corporate, and jointly administered or "Taft-Hartley". Each of those three categories held about the same percentage of their equity portfolios in the "target companies": 44%, 42% and 40%, respectively. But the fourth category of plans, "Not Collectively Bargained--Employer Control", had 58% of their equity assets in "target companies". Understandably, CDE put these 24 particularly egregious plans first. One might think that being "not collectively bargained", these are plans sponsored by just the kind of union-avoiding companies that would virtually seek out, from political conviction, investments in "predominantly nonunionized" firms, and evidently even in EEO and OSHA violators, etc. But in fact --a fact CDE does not acknowledge-- the report engages in that old sin of doublecounting. As these 24 plans' names show, these are thrift and profit-sharing plans, e.g., Sears Roebuck's, or AT&T's savings plan for salaried employees, etc. Of these 24 plans, 16 are sponsored by firms that are themselves "target companies" --Sears

---

*CDE does not believe its study is only a step, but intend that their data be used. Their only disclaimers were that the study is not a comprehensive source on all pension funds, nor a definitive study of corporate social performance, but of course on only 142 funds and on only four elements of 99 corporations' performance. (CDE Handbook, at p. 8.)

is "predominantly nonunionized", AT&T is an "EEO Violator". Mirabile, since savings plans are by definition invested largely or wholly in stock of the sponsoring company, a "target company's" savings plan does come up with a lot of "target company" stock. CDE's telling us this is like one of those hot bulletins that big banks are taking over big banking. Whether CDE's failure to acknowledge the double-count occurs because of ignorance, lack of integrity, or the license allowed to propaganda, some "audit"!

Flaw two is that the report black-lists bigness. Now I happen to be one of those people who is troubled by bigness. For example, for five years Senator Bentsen and I have been arguing, through several Hearings, that a trust department (particularly the Morgan) can be too big, with equity holdings in specific companies that are both improper and inadvisable simply because they are too big. But even people less troubled about bigness than I am, may believe that unfair attacks on big companies need not keep us awake at night, the big companies can take care of themselves. So I don't get upset if someone takes a foul shot at the big boys. But I do bleed for those innocent little statistics, which are distorted to suggest that someone is a bad "social performer" when that may not be so. Consider: CDE says a firm is an EEO violator if it signed a consent decree in which the monetary settlement was $100,000 or more. Regardless of the firm's size of payroll, age or turnover of workforce, etc. A firm is an OSHA violator if it was subject to a penalty of $25,000 or more, regardless of nature of industry, size of payroll, etc. (In this one instance, CDE did at least admit the problem: "[A] firm may have been cited once for a major violation but have a better overall safety record than other firms which have numerous, but smaller, fine records.")

So of course, one finds that the 38 EEO and OSHA violators are the country's biggest corporations, with only about five smaller firms, such little guys as Coors, Seatrain Lines, and Winn-Dixie Stores. A data screen as procrustean as CDE's is not telling us who's bad, but only who's big. GE, Merrill Lynch, US Steel et al will have large fines if such a company trips on the way to the bathroom. But does the fine reflect one unfortunate situation in a context of commendable practice? (Even a better data screen is inadequate if one stops with the data alone. Perhaps the one violation was not clearly anti-social: perhaps an OSHA violation occurred because the company--urged on by the local community and union--had decided against closing an old plant where modernization costs were preclusively high. Isn't such a situation at least different from simple law-breaking, and worthy of closer analysis?) Or perhaps the firm has come around since the violation? If, as some people say, AT&T and BankAmerica are today among leaders in equal opportunity employment, shouldn't we be emphasizing such stock holdings rather than avoiding them?

Flaw Three is that the report suffers the shallowness of prejudice, like the bigot who says "they" all look the same to him.

Thus among the 26 EEO violators are three firms chosen not because of CDE's crude screen, but because one was debarred from Federal Government contracting and two others were proceeded against for debarrment. Why does the report tell us this much but not name the hard-core debarred firm and the two firms proceeded against, or in any way distinguish them from the other 23? Many pension professionals would probably be willing, probably even eager, to avoid investment in the debarred firm. Evidently CDE believes that the Office of Federal Contract Compliance is no more able to determine what performance is so bad as to be illegal, than is CDE's biased-against-bigness, rigid, superficial data screen.

Flaw Four is that the report combines the shallowness of prejudice with the Cyclopean distortion: looking through only one eye, seeing only part of the picture. This is revealed most acutely in CDE's treatment of the 30 companies listed as "South Africa investors/lenders". CDE ignores the fact that involvement in South Africa may, by respectable perspectives, be doing good rather than harm. CDE ignores the fact that of the 30 firms they blacklist, 18 are subscribers to the Rev. Leon Sullivan's code of principles for doing business in South Africa. And 8 of those 18 were among the mere dozen companies which helped Sullivan get his code started. Sullivan's effort may be wrong: it may be that total withdrawal from South Africa is the better course, but that is a question on which we face disagreement among responsible authorities in all parts of the political spectrum. Apart from that very difficult question, it may be that Sullivan's effort doesn't go far enough in setting acceptable guidelines, even if Sullivan's is the largest effort to date to have business in South Africa act as a force for the kind of change all decent people seek. But why does the report not even tell us which companies are arguably less evil, i.e., Sullivan signatories?* It is one thing to have to use 1976 data; it is another to so wholly ignore easily available, crucially significant, more timely information. I would much like to know why 12 of CDE's 30 South African "targets" are not among the Sullivan code's 135 signatories -- e.g., AMAX, Coca Cola, Manufacturers Hanover, Owens-Illinois, United Technologies.

---

*Happily, CDE's disdain for the difference between Sullivan signatories and non-signatories is not shared by the UAW. UAW has secured from Chrysler the right to indicate five equity investments each year to be divested or avoided because they are involved in South Africa but have not accepted the Sullivan principles.

Significantly, the responsible UAW official has pointed out that the union's role is only advisory, the trustees themselves "retain full investment discretion and must exercise that discretion in a prudent manner." BNA Pension Reporter, Dec. 17, 1979, at A-18 (comment of Claude Poulin).

CDE's most one-eyed listing is its lumping Ford in with all the rest. The Sullivan principles' main weakness was that they did not speak to unionization. They do now, but Ford was ahead, being the first company in South Africa to recognize and negotiate with a black union. And Ford was one of only two American companies which contributed (and it made a larger contribution than the other, Mobil) to the South African bi-racial Urban Foundation, which helps blacks buy homes, provides electricity for black schools in Soweto, etc.

If we treat a company promoting black unions in South Africa just the same as companies not even willing to sign the Sullivan principles, haven't we lost sight of why we're concerned about involvement in South Africa in the first place? Perhaps the concern is not about life in South Africa at all, but about propaganda in America? (Incidentally, since many union pension funds --presumably the prime audience for the CDE report-- hold Israeli bonds, and since Ford's plant in Israel has provoked a virtual Arab boycott against Ford products, hasn't Ford a double basis for _inclusion_ in such fund portfolios, rather than being boycotted here too?)

Flaw Five is that CDE's vision is not merely one-eyed, it sees in monochrome a world that is polychrome. This is most amusingly shown by the inclusion of Control Data as a "target company" because "predominantly non-unionized" (as noted immediately below). Last Spring, Control Data directed the investment managers of its large pension fund, to add "social responsibility criteria" to their investment analysis. Control Data spelled out the criteria to be used in such detail that, considering the burden of getting the information to implement those criteria, either Control Data is engaged in a publicity stunt or they intend to devote to this effort all their assets --all the company's assets, not the pension fund's, will be needed to do the job they blithely assigned to their investment managers.* But since Control Data agrees with CDE

---

*As one of Control Data's two investment managers said of the research assignment, "you can't just go to a book and get it." (Pensions & Investments, Aug. 13, 1979, pp. 1, 38.)

Here are "examples of data that might be used" which Control Data suggested for three of its nine investment criteria:

"Equal Employment

- Publish EEO data periodically?
- Percentage increase in minority and female (professional) compared to total population increase over last five years?
- Number of complaints against company received by EEOC in last five years? Win/loss ratio?
- Existing lawsuits over EEO matters?

(Footnote continued on next page)

that social performance criteria should be used, shouldn't Control Data be one of CDE's favored investments (if there are any), but surely not blacklisted as they are?

Flaw Six is the report's unrealism. The distortion and unreality of CDE's list is established, not merely by argument, but by measuring the list against actual portfolios of groups well-known as "ethical" investors. CDE itself listed TIAA-CREF. That pension fund for university teachers, one of the very largest funds of all, had 42% of its equity assets in "target companies", only just below the 46% for the aggregate of 142 plans studied.

I looked at the portfolio of the United Presbyterian Church Board of Pensions, with $137 million in equities. They held 44 of the 99 "target companies". I looked at the portfolio of the Dreyfus Third Century fund.* This is a far smaller fund, $26 million, and invested almost without exception in the smaller companies in which a smaller portfolio can concentrate. Sure enough, even that fund held one "target company": interestingly, it was their only holding in a large non-financial company (UAL, an "EEO violator" according to CDE). Similarly the largest corporation held by another but minuscule socially-oriented mutual fund, Pax World, is a CDE "target", the "predominantly non-unionized" Sears Roebuck.** By no means do I fault any of these portfolios, but rather, the other-worldliness of CDE's list.

(Footnote continued from page 153)

"Environmental Commitment
- Existence of formal policies and procedures?
- Number of complaints against the company received by EPA or related agencies at state or local level?
- Existing lawsuits under environmental matters?
- Percentage reduction achieved in major pollutants over last five years?
- Percentage energy use reduction in last five years?

"Consumer Relations
- Formal mechanisms for complaint handling?
- Procedures used to insure product safety?
- Number of product recalls?
- Number of product liability complaints and/or lawsuits in last five years?"

*That is, the May 1978 information which is all they sent to an ordinary inquiry from a potential investor, in September 1979. A socially responsible fund?

**Pax World, started in 1971, has under $2 million in assets. Its net asset value rose in 1971 and 1972 but fell to almost 50% in 1974, and has declined in 1973, 1974, 1977 and 1978, rising

(Footnote continued on next page)

Going on in that other world: To blame companies for being "predominantly non-unionized" (i.e., U.S. workforce was less than 33% organized) is importantly different from blaming companies for being anti-union. Still, even CDE's criterion may be realistic when it means listing such retail or service firms as K Mart and Sears, Marriott and McDonald's. But does it make any sense to avoid investment in Control Data, Digital Equipment, Honeywell, IBM, Texas Instruments, etc., because they are predominantly non-unionized? Such companies probably will be "predominantly non-unionized" until unions inherit the earth. Avoiding investment in such companies will only hurt the investment returns of any fund so ill-advised as to use this report.

Finally, Flaw Seven is the report's disregard for investment returns. Typical of the report's care and integrity, the 142 funds are attacked for having almost half of their common stock holdings invested in these companies, "a high degree of concentration in relatively few securities." Now I give you only one guess what proportion of the S. & P. these 99 companies represent!

Going beyond that, the actual stock market performance of these companies over the last five years has been analyzed by Robert Levy, President of Computer Directions Advisors. He started with the top 99 institutional holdings as of September 30, 1974. The 99 companies were then split, Group 1 being the 38 of the institutions' top 99 which are among CDE's "target companies", and Group 2 being the remaining 61, presumably less objectionable firms. The first finding was that the "target company" group, though only 38% of the number of top institutional holdings, amounted to over 50% of the dollars invested in these top holdings. (How would pension portfolios be impacted if a fair number of them started selling, pursuant to CDE's advice?)

As for performance, 9/30/74 to 9/30/79: Equal dollar investments in each of the 61 non-target companies would have produced an average performance of 77.0%; similar investment in the 38 "target companies" would have produced an 83.4% return. Levy called this "a

---

(Footnote continued from page 154)

only in 1975, 1976 and 1979. Its ratio of expenses to average net assets has never been below 1.4% (unusually high for the industry), and since 1974 has been around or above 2.0%.

Is it worthwhile to accept the burden of such high costs to run so small a fund with so incredibly indirect an impact on the expressed goal, world peace? Wouldn't direct contribution of the sums so spent do far more?

How ironic that the 1979 Wisconsin Case Study, which itself cost $180,000 and which included treatment of Pax World and Dreyfus Third Century, relied entirely for its information about them on one New York Times article from early 1977. Wisconsin Case Study, supra, at 219-20, 224-5.

tribute to the wages of sin", and concluded that "social investing might be slightly dangerous to your financial health." (The above data do not include dividends.)

Examining CDE's effort will, I hope, have two results. First, it should reveal the difficulty of developing non-financial criteria. CDE listed as the very first "more significant finding" of their study, that "It is eminently feasible to review pension plan holdings in terms of social performance guidelines." Yes it is feasible, but it is difficult and costly unless one is willing to settle for data that are not only out-of-date but that are so crude as to lump leaders with laggards, thus inviting investment decisions which will be unfair to the portfolio companies, ineffective and even counter-productive for the social goals being pursued, and demonstrably dangerous to investment performance, especially for large portfolios.

Second, I hope it begins to become clear that although responsible "social performance" data are costly, they can be developed, and certainly I join CDE in believing they should be developed. But this will occur only if companies like Control Data, instead of merely seeking publicity about being "socially responsible" in their pension investing, actually try to implement that goal by joining with other major companies and major institutional investors, to bring us usable social performance data. We need the economies of scale if such data are to be sound and routinely available. Social performance data will make a difference <u>only</u> <u>if</u> sound <u>and</u> available on an on-going basis.

I would like to see such data available because I personally sympathize with most of the social goals in question. Also, I would like to see such data because I believe that poor social performance is a forerunner of poor financial performance.*

---

*"To be sure, the name of the game is profits, but the game is a long one." Wm. C. Greenough, The Power of Institutions, New York Times, May 2, 1971, §F, p. 14. Two security analysts, after comparing the pollution record and the profits of 17 pulp and paper companies, and finding that in that case the "good guys" came out ahead, concluded: "The most subjective determinant of the relationship between environmental responsibility and intra-industry profitability is good management. Creativity in dealing with pollution is likely to flow from more general management competence." C.N. Stabler, Heard on the Street, Wall Street Journal, August 4, 1971.

Recently the head of the U.S. Steel pension fund put it this way: "Does a chemical company with waste disposal problems, a railroad with a poorly maintained roadbed, a drug company under FDA fire get a price earnings permium when such news is released? Does a company with persistent labor trouble and work stoppages earn returns on its plant investment that would attract

(Footnote continued on next page)

Some pension funds, as well as other kinds of investors, would use such data, would be more satisfied with their own investment strategy, and would offer the entire financial community an invaluable experiment. A little more experience would be more fruitful than infinitely more debate.*

Implementation problem (5)--Conflicts of interest with the "targets" of the divergent investing. To the extent that the divergent investments are aimed to benefit--or bring pressure on--firms or ventures situated in the same locality or industry as the pension fund, consider what kinds of investments are actually likely to occur: those with political appeal, and often those which raise acute conflicts of interest. If a construction union invests in mortgages to finance a construction project on which its members will have jobs, are we confident that the projects will be selected by neutral criteria? If state and local pension funds are to invest in local projects, then once we abandon the discipline of seeking market returns, won't there be enormous competition for the pension fund dollars, with politics replacing market return as the determinant? Politics are the right measure of who get into office and how public policy issues are resolved. But whether one recognizes the importance of what is often unfairly derided as "pork-barrel", or one believes that "pork" is somewhere between inefficient and corrupt, contrast the safeguards surrounding political pork-barrel decisions, as against what will happen when the bees gather around the pension fund honey-pot. Not even the strongest and most representative pension board will have as much independence, as much political balance of countervailing forces, as a legislature. Not even the most major pension fund investment decision will have as much public visibility and relative comprehensibility as decisions being forged in our most public and accountable cauldron of compromise, the legislature.

In short, the pension fund is likely to be a captive source for whatever interests have the muscle--whatever form their strength may take--to shape the choice of divergent goals, and then the selection of specific investments. In addition, individuals and

---

(Footnote continued from page 156)

institutional investors? The answer in the market place is obvious." Statement of Graham O. Harrison on behalf of the ERISA Industry Committee (ERIC) before the President's Commission on Pension Policy, Dec. 10, 1979, at p. 12.

*"Most of the other issues surrounding 'social investing' are normative in nature and are not amenable to research. Some work has been done on the differentials in rate-of-return, but there is not enough evidence to draw any conclusions." EBRI, "Research Agenda", draft.

firms in the community as well as the pension fund itself are likely to be under suspicion even when there has been no abuse and its likelihood is tenuous. How much more troubled would be the flow of accusations and inquiries if traditional prudent investment criteria were surrendered. Consider these three episodes involving the highly prudent Wisconsin State Fund in the last three years:

a. A Milwaukee newspaper raised the notion of an actual or potential conflict of interest because of the Board's holding of Exxon Corporation common stock. Exxon had recently announced a major cooper discovery in Crandon, Wisconsin, which prompted the state legislature to revise the state's mining laws, including taxation of the ore removed. Members of the legislature are retirement plan participants and, in this case, could directly impact the Company's profitability.

b. A consumer group opposed to rate increases for one of Wisconsin's electric utilities suggested that our bond and stock investments in the utility might influence the Public Service Commission or members of its staff to grant the company's request because they, too, are participants in the retirement funds.

c. The editor of the University of Wisconsin-Madison's student newspaper questioned the terms and reasons for Investment Board mortgage loans to Kohl's Supermarkets, Inc., covering five food stores in Wisconsin. The company, a large regional chain, was founded in Milwaukee by the Kohl family, a member of which has served as chairman of the state's Democratic Party.

"While it proved easy to dispel the concerns suggested in each of these instances", the Fund's executive director testified, "the lessons for the Board were clear:

a. In the final analysis, the public expects investment decisions to be based upon objective financial criteria and facts.

b. The best indications we received from our beneficiary groups are that they too expect measurable financial results and do not expect or desire that we take on the characteristics of a charitable, philanthropic or industrial development organization.*

---

*Statement of James M. LaFleur, President's Commission on Pension Policy, Dec. 11, 1979, at 12-13.

Implementation problems (6) and (7)--We know how to measure a portfolio's or a single investment's performance. We even have mathematical techniques to measure the riskiness of the investment or portfolio and evaluate the return in light of the level of riskiness. We have adequate indexes against which to measure a portfolio's or an investment's performance, as well as being able to evaluate a portfolio in comparison with substantially similar portfolios.

If we diverge from traditional prudent investing with its sole focus on investment return (unless the divergence is of the moderate XX type, which by definition accepts no reduction of investment returns and therefore remains susceptible to traditional performance evaluation), how shall we evaluate the portfolio's performance? How on earth shall we evaluate the success, failure, or in-between impact, of the effort to further the divergent goal? In light of those difficulties, how on earth do we hold the portfolio managers accountable? Or do we deteriorate to the level of chowder and marching societies, keeping in office persons whom we like?

Despite the several implementation problems,* of course one can damn the torpedoes, act as if having the power to decide is the same as having the right to decide, and simply push ahead--remembering, if any prudence remains, to try in advance to get fiduciary liability insurance and able trial counsel.

N.B.: If in fact any divergent investments are made, the pension fund should disclose in its annual report which, why, and as much informantion as is feasible about the terms of, and returns on, the investment.

VII. Even if divergent investing is implemented, will it matter?

Implementing divergent investing is making it "work" in only the smallest sense. To make it succeed, still to be faced are three easily described "impact hurdles", obstacles standing in the way of the divergent investments' having any impact on the divergent goal.

First, the "displacement" problem must be overcome. If, for example, a pension fund buys stock in a firm because of its admirable, say, EEO record, or the fund sells or avoids some other firm because

---

*Even more implementation problems than the seven examined above must be noted. Virtually every study of "ethical investing", at least during the last era of interest in this issue, recommended that portfolios would find it imcomparably more feasible to exclude clearly bad, say, polluters or red-liners, rather than to try to include firms which are superior in "social performance". Similarly, it has been recommended that the "social evaluation" be limited to firms' direct conduct, rather than indirect involvement with undesirable (or desirable) conduct. See studies cited in Longstreth & Rosenbloom, Corporate Social Responsibility and the Institutional Investor (1973), at 72, 74, 80, and 84.

of its deplorable record, what reason is there to believe the fund's purchase or sale will have any impact on the company in question? Massive liquidation or accumulation of a security will move its price, but the bigger the company--and by definition it is the bigger companies' conduct that must be the focus in corporate "social performance" --the harder to affect the stock price. If a company is as egregious as J.P. Stevens, a coordinated campaign may bear fruit (though, much as I wish J.P.Stevens had been brought around, have they been?). But such instances are clearly the exception. In the main, the only impact of an investment motivated by divergent goals will be the displacement of the selling security holder by the purchaser. Achieving, sad to say, not only zero impact on the company or area, but also no more notice for the fund's view's than the tree falling in the forest with no one to hear it. To avoid displacement, the divergent investor must evaluate the significance of the size of its investment relative to the "target" in question.

The second "impact problem" involves "leakage" and "multipliers." Will an investment in a firm because it has a fine EEO record, actually do anything to promote equal employment, or will it go into uses having no relationship to the conduct motivating the investment? "Leakage" is most obvious when it comes to trying to make a "local" investment. Even if the borrowing company is local, unless all its activity is local, how be sure that the local community benefits from the investment? Or even if the company is wholly local, what if the funds are used to purchase new equipment to make the firm more profitable by reducing labor costs? (The converse, or "good leakage", has been faced by TIAA/CREF, which has a long-standing policy against investing in alcohol or tobacco companies. In today's scene of conglomeration, a major tobacco company sought loan funds for non-tobacco ventures. Should TIAA/CREF ostracize the company on its way toward conversion? They made the loan.)

John Petersen has written concisely about these problems:*

> Whether and how much the local economy will be stimulated comes under the general heading of local multiplier theory and analysis, which concerns itself with measuring the effects of an increase in final demand on the output and income of the region.
>
> A major constraint to the local stimulation possibilities is that many, often most of the dollars will leak off into other regions of the country and will not

---

*From Petersen & Schotland, Socially Useful Investments by State and Local Pension Funds: Concepts and Issues (Spring 1979). See also Petersen, Keeping the Money at Home, Hearings on Pension Fund Investment Policies, Senate Judiciary Committee, Subcommittee on Citizens and Shareholders Rights and Remedies, Nov. 21-2, 1978, at p. 279.

stimulate the local economy. This can happen if the area is small and does not supply much labor or many goods to the process in question.* Furthermore, construction may last for but a short period of time and so may its effects. The project financed may not be income-generating in the sense of having a permanent workforce and a product that is capable of support in the private market.

And Marc Gertner has made the matter concrete:**

Northwestern Ohio, like many areas, has inadequate low and middle-cost housing for the elderly. In 1977, a developer came up with a package for a 10 story high rise, 75,000 square foot apartment project for the elderly. Let us run out the impact of this project if conventional, 80 per cent financing is granted by either the pension plan of a large construction trade union or a small construction trade union. The project is the ultimate in social investing since it provides housing for the elderly -- that's a socially responsible action -- and provides jobs for members of the union.

The total project cost of the real project was $2,375,212; so the mortgage loan will be $1,900,000, rounded off. In fact, this represents 82.6 per cent of the trust fund of the smaller union. Absence of diversification is not my point here. Of the $2,375,292 total project costs, $2,130,292 is the construction cost. But of this amount, $1,032,835 will go for materials, leaving only $1,097,457 for labor. The subcontract for the trade of the smaller union on this project was $9,720, of which $5,720 was material cost and $4,000 was labor. The current collective bargaining agreement between the smaller local union and the corresponding employer association called for a wage rate of $12.63 per hour. Thus, the trade's subcontract would generate 317 hours of work. If there was a six man crew on the job, the loan of $1,900,000, 82.6 per cent of the trust fund, provided about seven days' work for a six man crew. Is this desirable social responsibility?

---

*For example, a small rural area will tend to have a very small multiplier in comparison to a large, highly developed region of several states. Most of the first dollar spent will simply be spent outside of the small community to buy goods and services from the rest of the state and national economy.

**From Shumaker, Loop & Kendrick, Memo to Board of Trustees, A Program of Socially Desirable-Socially Responsible Investments: A Bad Fad in Prime Time, Sept. 5, 1979, pp. 19-20.

If we walk it through for the larger union, with the larger pension trust and a bigger slice of the project contract, it provides the mortgage of $1,900,000 from their pension trust fund with only 15.8 per cent of the total. Again, of the $2,375,292 total project cost, $2,130,292 is the construction cost. Of this amount, $1,032,835 will go for materials and $1,097,457 will go for labor. The subcontract for the trade of the larger union is $153,090, of which $93,090 is for materials and $60,000 is for labor. The current collective bargaining agreement between the union and the employer association sets a wage rate of $13.80 per hour. This project will generate 4,348 hours of work. Assuming a crew of 20 men, an investment of $1,900,000 or 15.8 per cent of the trust, or more than 6 months of contributions, will provide a crew of 20, which is 1.6 per cent of the membership of the local, with work for 5 and 1/2 weeks. We submit that this is not a favorable trade off. We submit that an investment of the $1,900,000 in a recognized investment, with a higher rate of return, with greater liquidity and marketability, with an established credit rating, would be a more responsible investment of 15 per cent of the trust for 98.4 per cent of the participants.

The last impact problem--and last hurdle I will note--is what I call "interference." The pension fund's investment impact may run into forces running in the opposite direction. The most direct example of this problem is Richard Ennis's hypothetical about a state pension fund:*

> A Case Study--Widget Enterprises Inc. (WE), an employer of several thousand people, announces its intention to close its plant in State A and move to State B, citing two reasons for the move: its plant is old and not as efficient as plants recently built by certain competitors; and, more importantly, wage rates are much lower in State B. (State A's labor force is widely represented by trade unions and State B's is not).
>
> A review of WE's financial statements reveals that currently it costs WE $3.00 to manufacture a widget ($1.00 labor, $1.00 raw materials, $1.00 debt service). The competitively determined market price of widgets in the U.S. is also $3.00, and, therefore, WE is not making a profit. WE's management estimates the manufacturing cost of widgets in State B to be only $275 because of wage differentials,

---

*Pensions & Investments, Oct. 8, 1979, pp. 33-34.

allowing a pre-tax profit of 25¢ per widget. (Labor is 25% cheaper in State B. Therefore, wages are expected to be 75¢ per widget; raw materials and debt service remain at $1.00 per widget.)

Upon WE's announcement of its intention to move, the Widget-makers International Union, in order to keep several thousand jobs and substantial tax revenues in State A, initiates a program to persuade the State Legislature and the Governor's Office to cause the State Retirement System to grant to WE a series of loans at three-fourths the going rate. This interest rate subsidy is calculated to reduce the cost of WE's debt service enough to offset the higher wage rates in State A, enabling WE to build a new plant to manufacture widgets at a cost of $2.75 each ($1.00 labor, $1.00 raw materials and 75¢ debt service). The State Retirement System agrees to make the loans and extends a proposal to WE.

Widget Enterprises considers State A's proposal. Before long, WE announces its intention to accept State A's proposal and to construct a new plant right next to the old one. Production costs will now be lower in State A, affording a pre-tax profit of 25¢ per widget. Everyone is happy.

Everyone, that is, but the people of State B. Not wishing to lose the tax revenues anticipated with the arrival of WE, and hoping to reduce State B's unemployment rate, the Governor of State B contacts WE management with this proposal: "Move to State B as originally intended and we will make the same (subsidized) loans to build your plant from our pension fund." WE's alternatives are now as follows:

	Remain in State A	Move to State B
Revenues per widget	$3.00	$3.00
Less:		
Labor Costs	1.00	0.75
Raw Materials	1.00	1.00
Debt Service	0.75	0.75
Total Cost per widget	$2.75	$2.50
Pre-tax profit per widget	$0.25	$0.50

It is clear that Widgets can be manufactured 25¢ cheaper in State B with or without pension fund subsidies, because unit labor costs are still 25% cheaper there.

Lest Ennis' hypothetical be thought artificial: James LaFleur, executive director of the State of Wisconsin Investment Board, points out that that fund had made a $1,700,000 private-placement loan to Kearney & Trecker, a Milwaukee-based manufacturer of machine tools. Upon Kearney's merger with The Cross Company, a Michigan-based machine tool firm of about the same size, the new combined headquarters were located in Detroit. The choice went against Wisconsin because of what the firm's chief executive called Wisconsin's "adverse tax structure related to capital gains, inheritance and personal income taxes."

Divergent investors not only face insurmountable obstacles in deciding what to do, how to do it, and whether doing it will matter--but other parts of their own team may be running inconsistent plays.

VIII. Alternatives Superior To Divergent Investing

Increased mortgage-related holdings. "Too much investment in corporate securities" is one attack advocates of divergent investing make against traditional pension investing. Mightn't they be right?

Outstanding mortgages in American total $1,173 billion, in contrast to corporate bonds' (and foreign bonds held here) strikingly small $422 billion.* Yet private non-insured pension funds, with aggregate assets of $200 billion, hold $48 billion in corporate bonds, but an amazingly small $3.1 billion in mortgages. State and local pension funds, with aggregate assets of $153 billion, hold $81.4 billion in bonds, $8.7 billion in mortgages.

Direct mortgages, even if Federally guaranteed, have been understandably unattractive to pension funds: there is the need to service the mortgage, the lack of liquidity, the problem of valuation, and the possibility of total return of principle at an unanticipated time (or, if the mortgage is not insured, then possible impairment of principal and certainly more administrative burden). Thus even at periods when yields might spread well above high-grade bonds, the spread was almost never enough to induce pension investment.

Even most of the funds most sympathetic to mortgage investment, the building and construction trades union pension funds, held only minuscule amounts of direct mortgages.** Of the 11 largest

---

*Table 1, at end of paper.

**See Table 3, reporting the 1975 holdings (the staleness is attributable to the familiar difficulties in retrieving 5500's

(Footnote continued on next page)

such funds-- with aggregate assets then of $2.1 billion--three held no mortgages directly and only 5% or less of their assets indirectly via FNMAs, GNMAs, etc. Only four of these 11 funds-- the ones likeliest of all pension funds to hold mortgages -- had substantial mortgage holdings. Three of the "moderate," last four funds had 3% or less of their assets in direct mortgages, and only another 5% or less in indirect mortgage instruments.

Two union-sponsored efforts to help fund union-labor-constructed projects, the AFL-CIO's Mortgage Investment Trust and Union Labor Life Insurance Company's "J for Jobs" account, enjoy hardly more than token size, considering the over $2 billion in just the construction union pension funds, let alone the $11 billion in just the top 25 Taft-Hartley funds. The AFL-CIO Trust, started in 1964, had $69 million as of September 1979; the "J for Jobs" account then had $27 million and could readily place much more.

But the past few years have witnessed a "revolution in mortgage finance"** which pension funds --especially the private non-insured-- have been slow in taking advantage of, and our statisticians have been even slower in revealing. There has been a proliferation of forms of indirect mortgage securities such as GNMAs, and a virtual explosion in the dollar amounts outstanding:

(Footnoted continued from page 164)

from the Labor Department) of 10 of the 11 largest such funds. For information on the one missing from our Table, see C. Bruce Sutherland, Mortgages and Real Estate: A Partially Ignored Investment Medium, Employee Benefits Journal (Fall 1977), p. 14. (Carpenters Fund of Northern California, assets then of $275 million, 32% in mortgages (including a relatively small amount in real estate).) In Table 3, one fund, "IBEW-Members," is not a Taft-Hartley but the dues-funded Electrical Workers' pension fund. The "NBEF" fund is a Taft-Hartley, the National Electrical Contractors Benefit Fund.

**Morgan Guaranty Survey, The Revolution in Home Finance (November 1979); Federal Reserve Bank of New York, Quarterly Review, Mortgage-Backed Securities: The Revolution in Real Estate Finance, (Charles M. Sivesind) Autumn 1979, p. 1.

Outstanding Amounts of Mortgage Pools or Trusts*

($ millions)

	1975	1976	1977	1978	1979-Q1
GNMA	18,257	30,572	44,896	54,347	57,955
FHLMC	1,598	2,671	6,610	11,892	12,467
FmHA	14,283	16,558	18,783	22,394	24,129

* * * * * * * *

And to those should be added:

	1975	1976	1977	1978	1979-Q1
FNMAs	31,824	32,904	34,369	43,311	46,410

In fact, pension funds do hold substantial amounts of the new mortgage-related securities, but our statisticians lump these several-year-old instruments in with "U.S. Governments and Agencies."** (This is most tellingly revealed by the latest U.S. Census data on state and local pension funds' portfolios.*** One state fund, which had been carrying its mortgage-related securities as "mortgages", reclassified them --or the Census did-- as Federal Agency securities. The sum involved, $1.8 billion, a mere 20% of all state and locals' holdings of all Federal Agency securities.)

We are just beginning to uncover the amounts of mortgage-related securities in pension accounts. A sample of 19 state funds, each over $500,000,000 in assets--almost one-third of all state and local funds that large--shows eight with mortgage-related securities at over 50% of their holdings of all U.S. Governments; four of the eight are over 80%.**** And for a number of the funds, these figures are probably understated (see note to table).

---

*Federal Reserve Bulletin, Sept. 1979, p. A41.

**So far only relatively tiny amounts of private mortgage-related securities have issued, and only very recently. It seems clear this category will increase importantly, but it is not yet pertinent here.

***U.S. Bureau of Census, Finances of Employee Retirement Systems of State & Local Governments in 1977-78, p. 3.

****Table 4.

As for private pensions, the only data I know of are indirect (except for Table 3, on 10 union pension funds). (GNMA apparently has no data on private pension holders of their securities; they do estimate 10% of GNMAs are held by public pension funds.) The new Federal banking agencies' annual form on trust department discretionary assets, gathers first-time data on "real estate mortgage pool pass-through certificates", such as GNMAs. According to these data (not yet published), trust departments held at end-1978:

a)	Aggregate discretionary assets:	$441.8 billion
b)	Included in a), employee benefit* assets of:	$182.2 billion
c)	Aggregate holdings in U.S. Govts./Agencies:	$ 49.9 billion
d)	Included in c), employee benefit holdings of:	$ 21.998 billion
e)	Aggregate holdings in real estate morgage pool pass-through certificates (not available separately on employee benefit category):	$ 6.319 billion

Even if we assume that all the mortgage pass-throughs are held in pension accounts, we see that the great bulk of private non-insured pension assets hold strikingly smaller positions in these new securities, than do the sample of state funds. (Some of the difference is probably attributable to different treatment of FNMAs. Again noting that my state figures are probably understated, the main point surely is that better data should be assembled. This is not an academic point: as the picture emerges of just how large are existing pension positions in these securities, they will get larger.)

Why are private pension funds apparently much less inclined than public funds to hold these investments? One argument is that these attractive investment vehicles are new, and private pension managers, particularly trust departments, are simply not familiar with much other than corporate securities and traditional Governments.**

---

*These are overwhelmingly pension accounts, but also include profit-sharing, welfare funds, etc.

**Rosen, The Role of Pension Funds in Housing Finance, Jt. Center for Urban Studies--MIT/Harvard, Working Paper No. 35 (June 1975).

"Ginnie Maes," "Fanny Maes," "Freddie Macs," and on through the family including the new private-sector little cousins like Connie Mae, Maggie Mae, Pennie Mae, and MacMumbles (Merrill Lynch's), are at certain times clearly attractive for pension funds, indeed may be a classic "XX-type" investment offering both good returns and something extra as well. They have high liquidity, and no valuation problems. If a fund wants to have certainty about when principal will return, why not FNMAs? If a fund is not so limited in its accounting that it cannot cope with periodic but varying returns of principal, why not pass-throughs? However, pension funds will buy more mortgage pass-through securities if the issuers will add securities with two features not available now: First and clearly in the interest of general efficiency would be pass-throughs which make not monthly, but quarterly or semi-annual payments. This would facilitate holders' accounting and cash management enough to draw in pension funds not participating now. Second and less simple, but no less attractive to draw more pension investment here, would be securities with longer effective maturities.

During 1977-78, mortgage yields averaged about 70 basis points above yields on AA corporate bonds, a spread not seen since the late 1960s.* And even without Federal guarantees, mortgages are slightly less risky than high-quality corporate bonds.**

A last note: advocates of divergent investing enthuse about the fact that mortgages, even GNMAs, can be "packaged" for a specified State; many can be packaged even down to census tracts.*** This brings us back to risks of divergent investing. The narrower the package, the less the liquidity, therefore the higher should be the yield. Also, the narrower the package and more concentrated in one area is the investment, then even with a guarantee against loss of principal, there may be concentrated defaults and thus unantici-

---

*Morgan Guaranty Survey, _supra_, at p. 124.

**Rosen, _supra_, at pp. 161-166.

***See Staff Report of Subcommittee on Antitrust, Monopoly and Business Rights, Senate Committee on the Judiciary, Beneficiary Participation in Private Pension Plans, 96th Cong. 1st Sess. (1979), pp. 28-42.

The Hawaii Employees' Retirement System since 1959 extends direct home mortgages to its participants. As of June 1979, such loans totaled about $300 million representing 30% of the system's total assets. Rates are set each six months. Thus in June 1979, the Board set 10%, 10 1/2% and 10 3/4% for loans up to $75,000, $112,500 and $125,000, respectively. Loan rates are usually one percent or more below market rates. Query whether Hawaii's several unique circumstances warrant this element of divergence from Internal Revenue Code requirements.

pated, untimely return of principal. So once again we see that a sound pension investment can be soured by asking too much of it.*

<u>Joint participation</u>: If a pension fund is inclined to undertake some divergent investing, one of the surest ways to safeguard against the many difficulties and dangers of implementation, one of the likeliest methods of assuring that the pension fund's action will make a difference, is to join other financial institutions in joint participation on the same terms. For example, it is the rare bank, thrift, insurer, or private or public pension fund, that cares no more about its own geographic community than about other places and other ventures. If a pension fund tries one or another form of local development on its own, it is too likely to make unprofessional judgments as a result of lack of expertise, too likely to suffer severe reactions if the investment is unsuccessful, and too likely --if a public fund-- to be a captive subjected to poor terms behind closed doors. Such problems fall away if the pension fund takes, say 10-30% of a local venture shared, on the same terms, with local financial institutions.

The pension fund, acting as catalyst, will be better protected and more effective.

<u>Direct governmental or similar action</u>: Divergent pension investing will do less to promote the desired non-market goals, than would more direct devices such as special subsidies, or ESOPs, or the recently-enacted GSOPs, or SBICs and MESBICs, or regional

---

*The danger of a good concept being converted by divergent goals into a bad investment pattern, is capsulized best in <u>Pensions & Investments</u>' "Quote of 1978" (Dec. 18, 1978, p.36):

> "And it's too bad, because the real estate in the other funds is what makes them so good." A public relations person for the Intl. Brotherhood of Teamsters, commenting on the fact that the pension fund of Teamster officials has no assets in Las Vegas casinos, golf courses or other types of real estates found in other Teamster funds.

development efforts or outright grants from government, eleemosynary or private sources.* Advocates of divergent investing will almost surely get farther toward their goals by pursuing the enormous range of direct methods tailored to meet specific problems.

Pension fund investing is no better designed to do all jobs than could any single tool accomplish all the tasks of carpentry.**

Pass-through of proxies: A useful step to increase the "socially responsible" handling of pension assets is already under way. Starting about three years ago, Citibank's trust department has been revising its pension management agreements

---

*A canvass of the variety of efforts already underway is in James Rowen, Public Control of Public Money, The Progressive (Feb. 1977). Unfortunately advocacy is more exciting if its ideas sound new; e.g., in that article the imaginative use of state bank deposits is attributed to recent activist efforts instead of to the practice's origination seven or eight years earlier by then-state treasurer of Illinois Adlai Stevenson III.

**One direct step which has been confused with divergent investing is selecting an investment management firm which is compatible with the pension fund sponsor's goal. Thus it is hard to see why a Taft-Hartley fund should have as its manager an anti-union financial institution. The range of available managers is so broad, and the non-investment criteria for selection are so few, so clear and so unlikely to change, that putting investment management into compatible hands seems unexceptionable.

Manufacturers Hanover's severance of its interlocking directorate with J.P. Stevens, a step taken in response to pressure from unions with pension assets under management at that bank, seems to me wholly correct in light of the repeatedly established illegality of J.P. Stevens' conduct (see p. 37 above). The same union pressure utterly failed when aimed at Seafirst (parent of Seattle First National Bank), where no illegal conduct was involved. For an alleged authority to "say caustically: 'I don't think there will be many banks as yellow as Manufacturers Hanover'", as did the chairman of the Wharton School's Labor Relations Council in a recent Fortune article, is merely to reveal ignorance of the facts and a passion to be quoted. Raskin, Pension Funds Could Be the Unions' Secret Weapon, Fortune, Dec. 31, 1979, 64, 67.

However, it may become problematic if compatibility for a state or local fund is deemed to mean an in-state or local institution. Such a selection may be sound in any State, but the smaller the State and fewer the institutions to select among, the less likelihood that the interests being served are the pension participants' or the taxpayers', but instead the local institutions'. See Kohlmeier, Conflicts of Interest in State and Local Pension Funds (Twentieth Century Fund, 1976).

with many sponsors to have proxy votes exercised not by the trust department, but back at the pension account principals (e.g., in the case of Taft-Hartleys, the plan sponsors; in the case of profit-sharing plans, a committee of participants). To get some idea of how acceptable the "pass through" is to Citibank and its employee benefit clients, consider:

Citibank's . . .

employee benefit pension accounts	12/31/76	12/31/77
--Market Value............	$7,120,000,000	$7,449,000,000
--% of total proxy voting authority passed through..........	37%	58%

(Source: Citibank Investment Management Group, 1976 Review at p. 20, 1977 Review at p. 35). The 1978 data are reported differently: of $863 million in profit-sharing and thrift plans, 74% of the proxies are passed through; and 46% of the $5,104 million in defined benefit pension plans are passed through. (1978 Review at p. 25).

The above data include pass-throughs to most of the jointly-administered plans managed at Citibank. However, it is important to note that four such plans did refuse to accept pass-throughs, preferring to have Citibank remain responsible for the voting as well as the investment decisions.

The above data do not include any pass-throughs in the case of single-employer defined benefit plans, and while I have been going back-and-forth on pass throughs for the largest of all categories of assets, I believe that even there, pass-throughs are desirable. Let me explain why that category presents some question.

I do not believe that any plan with pooled assets should be required to send the proxies to all the participants; the simple costs of doing that are preclusive. As for a single committee of participants, while experimentation along such lines seem desirable, I wonder about the utility of committing the kind of time that such a committee inevitably involves. For example, in the 1977-78 proxy season, Harvard University's proxy committee --consisting of four students, four faculty and four alumni, with at least one administrator always sitting in-- met 25 times over a 5-month period. They had the wisdom to concentrate on developing policies for key issues rather than trying to take each vote as it came. Yet in President Bok's statement, he noted the time burden: "I am not speaking here of a few hours of meetings added on to a normal day's work but of hundreds and hundreds of hours taken away from [other] pursuits."*

---

*Bok, <u>supra</u>, letter on Ethical Responsibilities, p. 3.

What about pass-through back to the single-employer sponsoring corporations? It is argued that a new problem emerges if, let's say, Bankers Trust stops voting GM's pension plan proxies and instead GM votes them. Even if GM can make neutral proxy decisions when it votes shares it may hold in, say, Firestone or Ford or PPG or Pullman, some might worry about the hassle that might develop whether GM votes for or against the managements of any such corporations. Perhaps the professional investment managers, even if more concentrated, assure us more neutral voting and far less distraction of energies and emotions?

I come out for deconcentration, through pass-through. My discussions with persons responsible for one of the largest internally managed pension funds convince me that even for single-employer defined benefit accounts, the plan sponsors can neutrally and efficiently conduct the voting. For example, that large fund almost always votes against management proposals to authorize additional shares, unless management gives some statement of purpose. They also closely scrutinize management or employee compensation proposals. That fund even voted against a compensation proposal of a corporation whose chairman sat on the board of directors of that fund's own sponsoring corporation. Moreover, the fund always contacts a portfolio company's management before voting against them, so that the fund's rationale is explained and so that the fund is fully informed before it votes. While on at least one occasion such communication led to hostility in a portfolio company's management, this pension fund believes it has had no problems in voting several billion dollars worth of proxies. (Note, by the way, that this pension fund's practice, and all discussion of pass-throughs, assumes that the "Wall Street Rule" --"if you're thinking about voting against management, you shouldn't continue holding the stock"-- is illogical and irresponsible.* That is another subject, even if simple and brief.)

---

*"The 'Wall Street Rule' really has two faces, blind allegiance to management and unexercised voting privileges." Statement of Charles A. Moran, senior vice president of Manufacturers Hanover Trust Co. and chairman of the Employees Trust Committee of American Bankers Ass'n., Trust Division, before President's Commission on Pension Policy, Dec. 10, 1979, at p. 4.

I see no reason against, and all reasons for, having institutional accounts' proxies passed through back to the account sponsors.* By definition, matters fit for shareholder proposals are susceptible to resolution without professional investment expertise, which is so different from the situation of investment decisions. Also, voting will not interfere with investment returns, since either the results of the votes will have no discernible impact on the stock price or, if impact is a realistic possibility, then any intelligent investor would have sold out before the vote rather than merely hoping the result comes out right. If investment considerations are believed to be pertinent, it is easy enough to secure the investment manager's views. Citibank has made the point plain: "In our view, the right to vote is inherent in stock ownership--not in its custody or management. Consequently, we follow a deliberate policy of passing through, insofar as practicable. . . ."**

If participants in pension plans care enough about how their plan's proxies are voted, they can at least form an advisory committee furnishing policy guidelines or even suggestions on specific votes.*** If they do not choose this route, or cannot cope with its burdens, surely they cannot handle the incomparably tougher tasks of divergent investing.

---

*Of course any law so directing institutional investment managers should be limited to managers and accounts above a specified minimum size, lest the law include instances in which so little is involved that the gains from the pass-through are not worth the cost. Congress has required pass-throughs in the Revenue Act of 1978 (§ 143) with respect to ESOPs and similar plans. See also Tax Reduction Act of 1975, § 301(d)(5). Pass-throughs are also required of broker-dealer firms, in significant voting matters, by SEC and exchange rules.

For experience with pass-through voting and data about its treatment in savings and profit-sharing plans, see statement of Adrian A. Collins, Exxon senior tax counsel, on behalf of Profit Sharing Council of America, President's Commission on Pension Policy, Dec. 10, 1979.

**Citibank, Investment Management Group 1976 Review (1977), at 19.

***The advisory committee route has been challenged as flawed: "Can it draw busy, able, informed people to meet for serious review, yet concede they have no real power to assert their views? Moreover, committee member-

(Footnote continued on next page)

Whoever has the proxy voting power, the pension fund should disclose annually how its votes were cast: this can be done in very brief form as the Morgan Guaranty and Citibank trust departments do, reporting the number of votes against management.* There is no reason not to make available a list of the major issues and companies involved: California Teachers' Retirement System, holding stock in over 70 companies, previously noted the availability of such a list in their annual report, and now puts the list right into the annual report. (See 1977 Report at 49, and 1978 at 57-9.)

(Footnote continued from page 173)

> ship itself should be as representative as the underlying plan assets attributable to participants. Yet, to make any committee function on a range of economic and social questions in the time span available to review stock proxies is to assure inequities."

Statement of G.O. Harrison, President, U.S. Steel and Carnegie Pension Fund, on behalf of ERISA Industry Committee (ERIC) before President's Commission on Pension Policy, Dec. 10, 1979, at p. 10.

I agree with Mr. Harrison's concern, and as I testified in opening the same Hearing, participant involvement should be on the governing board, not merely looking in from outside:

> "As for corporate pension funds, I know of only one exception to the flat statement that employees, both active and retired, have no role at all in pension plan or fund governance. (The one exception is Citibank's pension plan for its own employees.) Such paternalism is perfectly appropriate at, say, U.S. Steel, where the company stands liable for their pension promises. But since the great majority of corporate pension sponsors insert a dubious provision that only the pension fund, not the employer, is liable for payment of the promised benefits, it seems clear that these disclaimers should be scrapped (as there are other good reasons to do) or the pension trustees must include representatives of both active and retired employees."

*In 1978, Morgan voted against management proposals 26 times and against management recommendations on shareholder proposals four times. (Trust Div. Rpt. for 1978, at 21.) Citibank opposed six management proposals and favored five shareholder proposals. (Citibank IMG 1978 Review, at 25.)

Shareholder activism: Responsible proxy voting, and even joining in offering shareholder proposals, is as different from divergent investing as speaking out is different from pouting in silence. "We aren't out to nail corporations, we are out to influence them" is the perfect explanation the Sisters of Loretto give for holding stock in J.P. Stevens and conducting a shareholder campaign againt Blue Diamond Coal, a firm which has been indicted for violating federal mine safety, sued civilly because of its explosion killing 26 men, and involved in violence surrounding an unsuccessful UMW strike.*

One of the best arguments for shareholder activism comes from one of its first practitioners, Professor Donald Schwartz, a principal of "Campaign GM":**

> It has also been suggested by some commentators that the proper way for shareholders to register their displeasure with management is to sell their stock, not to try to reform the corporation from within. If enough disgruntled shareholders sell, the market pressure would reduce the price of the stock and make management vulnerable to a take-over. . . .
>
> This alternative sounds fairly ludicrous when spoken in the context of General Motors. It bears no relationship to the shareholder of any company whose disagreement with management concerns social responsibility. It is unrealistic to expect a selling wave in a profitable company because of a disagreement over social policy. Management need not adjust its policies to avoid a raid prompted by a desire to convert the company into a socially responsible one--social irresponsibility may well have caused higher profits and stock prices, hardly an atmosphere conducive to a raid. The take-over threat, as a response to social inactivity, is a myth, or worse, a decoy.
>
> Moreover, under this alternative shareholders unhappy with social policies are told to pursue a strategy unrelated to their objective. Their objective is to convince managers and shareholders to adopt certain policies. They are not seeking the personal catharsis that might accompany disassociation from distasteful policies. Thus, selling stock in a company that discriminates against blacks might be good for the spirit, but it does not directly affect the company; rather it would place the stock in the hands of persons who either favor the policy, or at least are indifferent to it. So the objectionable policy would be strengthened by selling.

---

*"Here Come the Nuns", Forbes, Oct. 1, 1979, p. 118.

**Schwartz, The Public-Interest Proxy Contest: Reflections on Campaign GM, 69 Mich. L. Rev. 419, 475-6 (1971).

Moreover, shareholder activism has mattered:*

In 1978, Beatrice Foods and Standard Brands adopted nutrition responsibility policies similar to those of General Foods, which grew out of discussions between the companies and the shareholder groups.

In its 1979 proxy statement, Abbott Laboratories stated that, regarding two new Third World marketing practices, "Both of these items were generated with input from concerned shareholder groups."

In 1978, Gulf agreed to a church resolution (subsequently withdrawn) to adopt a policy prohibiting political contributions in South Korea. . . .

Citibank has pledged to make no more loans to the South African government but rather to limit "its credit selectively to constructive private sector activities that create jobs which benefit all South Africans.". . .

Finally, there are a few examples of management support for a social action resolution. In 1977, Exxon was preparing a report on its coal mining activities. Church groups submitted to Exxon two resolutions requesting information about strip mining. In meetings between the two groups, both agreed to revise and combine the two resolutions into a single proposal, and Exxon's board of directors urged shareholders to vote in its favor. The resolution received 98.7% of the vote. Such agreements are rare.

And pension funds have been heard from on stockholder proposals and similar matters. Ohio Public Employees Retirement System, holding 280,000 shares of McGraw-Hill, was one of the few stockholders to protest openly against management's being the final arbiter of whether to accept American Express's tender offer. That same system and Minnesota's State Board of Investment, voted against re-election of Northwest Airlines directors because of poor labor and customer relations. Minnesota's Board is currently considering strengthening its statement of policy about its role as a shareholder (see Appendix), and other state funds have similar policies.

---

*Purcell, Management and the "Ethical Investors," Harv. Bus. Rev., Sept.-Oct. 1979, at pp. 24, 30.

Even the route of shareholder activism has its costs, in significant time burdens at least. I noted above the "hundreds and hundreds of hours taken away from [other] pursuits" that Harvard commits to proxy voting (see p. 65). Few large pension funds will have fewer than 100 different equity holdings, many have over 200. U.S. Steel's fund, with over 200 issues, in 1979 had 123 stockholder meetings in April and 63 in May; over half the proxy statements they received were more than 16 pages long, and one-tenth were more than 30 pages long.*

The time burden (and direct costs to the extent that the institution seeks participant input) is even larger if the fund is to initiate shareholder proposals, "an option rarely used.... Its potentials for good are great, but so also are its dangers of misuse.** The prudent pension board is likely to seek protection against ill-considered proposals, and even against possibly unjust suits provoked by proposals despite the most careful consideration.***

Perspective must be retained lest the involvement in shareholder activism exceed its worth. Yet shareholder activism is clearly superior to divergent investing. Every vote, let alone every shareholder proposal, is an explicit, open communication of the fund's views, not only to the company in question but to the community in general. How can the route of divergent investing, so costly, so difficult to implement, and so likely lacking in any affirmative impact, compete against such superiority?

---

*Statement of G.O. Harrison, supra, at pp. 4, 6.

**Wm. C. Greenough, The Power of Institutions, The New York Times, May 2, 1971, § F, p. 14.

***When the United Presbyterian Church's General Assembly Committee on Mission Responsibility Through Investment wanted to use the Church's pension portfolio holdings to file shareholder resolutions, the pension board --chaired by Dr. Dan M. McGill-- understandably secured the following safeguards: (1) The Church's General Assembly Mission Council, not the pension fund, agreed to assume full responsibility, expenses and liabilities, including agreement to indemnify directors, officers, etc. in case of suits by the subject corporation or its shareholders, or by pension participants, etc.; (2) the Mission Council and not merely a committee would have to decide to file the resolution and would report its research, correspondence and visits with the subject corporation, etc.; (3) the Mission Council would purchase and maintain liability insurance satisfactory to the pension board to assist in the indemnification.

* * * * * * *

CONCLUSION

Divergent investing is unproductive investing and unproductive social action. More, it distracts us from productive efforts. It has been said that anyone can love children, but it is God's work to care for the elderly. Let us get back to work.

At least among the vast majority of people dependent upon or involved with pension plans, we ought to conclude upon the following guiding principles about divergent investing:

Point One: Retirement security is the exclusive primary purpose of a pension fund. This is true as a matter of law for any fund enjoying Federal tax advantages, which includes state and local funds. For private funds there is also ERISA, and for Taft-Hartley there is their statute as well. Divergent investing which may interfere with optimal investment returns to protect retirement security would require amendment of those statutes.

But going beyond the law, this is the major goal shared among a pension plan's participants and constitutes the *raison d'etre* of any pension fund.

Although the law is correct as it is, if any change is made it should merely allow pension funds to diverge from pursuit of retirement security, not encourage or in anyway require them to do so.

Point Two: Despite the fact that pension assets are huge and relative to other portfolios look even huger, in fact the pension liabilities --that is, the pension promises to be paid from these assets -- are so much vaster as to make the assets appear only barely large enough, at best. Especially among state and local pension funds, authorities indicate that there is such "under-funding" as to render today's $150 billion in assets severely inadequate. Recently accelerating rises in state and local governments' pension contributions are testimony to the rising political recognition of just how much it does cost to honor the pension promise.

Point Three: The exclusive purpose of honoring the pension promise requires that investment strategy be aimed at maximizing investment returns (at an appropriate level of safety of investment). Even in the minority of pension systems where the sponsor of the pension plan is liable to honor the pension promises whether or not the pension fund assets are adequate, the better are the investment returns the more secure will be the pension promise. Further, since inflation hits few groups as fiercely as it hits retirees, honoring the original pension promise now requires steadily raising the nominal dollars promised. Therefore the better the investment returns, the more likelihood of the retirees' being safeguarded against inflation.

Point Four: Maximizing investment returns in order to meet pension liabilities does not require blinders blotting out investments that may be not only as financially attractive as other available investments, but also may offer "something extra" desirable to the particular pension system. For example, at certain times Federally guaranteed indirect mortgage investment vehicles may be at least as attractive as other fixed income investments. For a system which favors investment in housing, such an investment at such a time (up to a prudent proportion of the whole portfolio), would seem obviously preferable to alternatives no more attractive in strict financial terms. Or, a church pension fund might understandably wish to exclude investment in firms involved primarily in armaments, alcohol or tobacco; in light of the vast range of investments such exclusion would still leave available, there would be no interference with investment returns.

Point Five: To the extent that any investments are selected (or avoided) on the basis of non-financial criteria, the following conditions are essential:

A/ An investment which is allegedly equal in return and relative riskiness to other attractive investments, but also has "something extra", must be examined with close scrutiny to assure that there is indeed no less-visible inferiority, such as lower liquidity. In the nature of a pension portfolio, not all investments need have high liquidity; but the lower the liquidity of any investment, the higher ought to be the yield. Even if a pension fund--as compared, say, to a mutual fund--may require only modest compensation in terms of higher yield to make up for lower liquidity, if the yield is not appropriately higher than more liquid investments then in fact that allegedly "equally attractive" investment is inferior and impairs retirement security.

B/ The pursuit of investments offering "something extra" in addition to meeting the need for retirement security is acceptable where the divergent goal being pursued is a "core goal", that is, a goal directly related to the essence of the institution sponsoring the pension fund. For example, a church fund's avoidance of firms primarily engaged in war materiel; or a Taft-Hartley fund's avoidance of a company that goes so far as to be held in contempt of court for violation of labor relations or related laws; or a state or local fund's preference, all other things being equal, for investments in its own area; or a corporate or Taft-Hartley fund's avoidance of investment in directly competing ventures.

C/ A divergent goal is less acceptable but still tolerable if it is only a "consensus goal", that is, one on which the pension board is certain that an overwhelming majority of the pension participants agree to that goal. For example, for many funds the avoidance of investment in the relatively few companies which are substantially involved in South Africa but which have not signed the Sullivan Principles and do not satisfactorily explain

their position, would be acceptable. No such consensus would justify avoidance of investment in all companies involved in South Africa for at least two reasons: First, the considerable controversy as to whether withdrawal from South Africa is better or worse than demonstrably progressive involvement there. Second, at least for large portfolios, such a substantial reduction of the range of potential investments is too likely to impair investment returns.

D/ Even in situations falling within the above-described "core" or "consensus" goals, the pension board should be certain that there is a direct relationship between the favored or disfavored investments and the non-financial conduct in question. Also, the pursuit of these goals, at least in the case of large portfolios, should not involve such sweeping inclusions or exclusions as to dominate or heavily affect the portfolio.

E/ Unless the pension board members can state with certainty that the divergent goals are "core" or "consensus" goals, then since it is clearly a breach of fiduciary duty for them to pursue simply their own goals, they may go no further without an opinion of counsel that there would be no breach if they took such steps as these: (i) With full disclosure, poll the participants and secured a majority (perhaps a substantial majority) of the retirees and other beneficiaries in pay status, and separately a majority of the actives, in favor of the proposed investment or investment strategy. (ii) Include on the pension board representatives of both retirees (including other persons in pay status) and actives.

F/ There must be full and periodic disclosure of: (i) all investments selected (or avoided) on the basis of any non-financial criteria; (ii) what those criteria were; (iii) what basis there is for believing that such investment or investment strategy in no way impairs investment returns; and (iv) what basis there is for believing that the investment or strategy has some impact--and what impact--in furtherance of the divergent goal.

G/ If any divergent investing is implemented, there may be additional costs for investment analysis or administrative steps. While costs would in some instances (like avoidance of alcohol or tobacco firms) be non-existent and in some instances might be minuscule and hard to isolate, in all other instances these costs should be borne by the pension sponsor, not the pension fund itself.

Point Six: There is need for thorough, periodic disclosure of comparative data about corporations' performance with respect to such major public concerns as equal employment, environmental quality, consumer protection, human rights, etc. Such data are important not only for advancing those societal concerns themselves, but also for the likely future financial success of the firms in question, and therefore of investment in those firms. Such data, if readily available, would be valuable in the course of ordinary

investment analysis. Also, they would be invaluable to any investor --pension fund or other-- that wishes to add divergent goals to its investment strategy. And they would faciliatate experimentation with divergent investing, thus advancing our understanding more than debate does.

Development of data about corproate performance regarding such matters will be costly. Large institutional investors --both institutions managing portfolios and institutions sponsoring such portfolios-- should, perhaps with aid from interested foundations, join together to make possible the development of such data. Once developed, the routine dissemination of such data will prove its worth by paying its own way, or else will prove itself a noble but unsuccessful experiment.

Point Seven: Many pension funds, especially private non-insured ones, may be under-invested in mortgages. This was understandable, indeed perhaps correct, when only direct mortgage investments were available. But now it is questionable, since indirect investment instruments, including vast amounts carrying Federal Government or Agency guarantees, are available. The sharp rise in pension holdings of these new instruments shows that they are well suited to pension portfolios. Awareness of the appropriateness of these instruments would be quickened and deepened, and consequently the amount of such pension investments would increase sooner, if the responsible Federal agencies, and perhaps the leading private firms active in these markets, would correct the severe lack of data about pension holdings in this sphere.

Point Eight: The pension funds and the retirees most vulnerable to pressure for divergent investing, even to the extent of injuring investment returns, are those of the state and local systems. Private pension professionals, not only out of professionalism but also as responsible taxpayers and citizens, have an obligation to become engaged in both informal and official forums discussing or deciding policy for state and local pension systems.

One of the first steps toward protecting the independence of state and local pension systems is to assure the stature of pension boards by having their appointive members (other than officials serving ex officio) approved by the relevant jurisdiction's advice-and-consent process; and also providing those members substantial, staggered terms in office. Pension boards are as much in need of and as entitled to independence, as many State's boards of regents overseeing educational institutions.

Point Nine: If a pension fund is inclined to undertake some divergent investing, one of the surest ways to safeguard against the many difficulties and dangers of implementation, and at the same time assure that the pension fund's action will make a difference, is to join other financial institutions in joint participation on the same terms.

The pension fund, acting as a catalyst, is better protected and more effective.

Point Ten: Recognizing the illegality, and independent of that the impropriety, of interfering with retirement security by any divergence from pursuit of investment returns, persons who want pension funds to pay more heed to non-financial goals should concentrate on the funds' voting of shares and perhaps even initiating (or joining others in initiating) shareholder proposals.

Table 1 :

Pension Fund Holdings as Percentages of Total U.S. Financial Assets

Source: Federal Reserve Board, Flow of Funds Accounts: Assets & Liabilities Outstanding, 1967-78 (Oct. 1979 revision)

($ in billions)

I. TOTAL ASSETS	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	Line
1 Total: Bonds, Equities, & Mortgages	$1620.1	$1821.8	$1787.9	$1868.4	$2110.6	$2351.8	$2291.3	$2210.5	$2589.6	$2991.6	$3216.8	$3559.0	1
1a U.S. Securities	$ 297.7	$ 315.1	$ 321.2	$ 343.0	$ 373.8	$ 397.4	$ 425.7	$ 459.9	$ 558.1	$ 646.7	$ 730.1	$ 825.3	1a
1b State & Locals	$ 113.7	$ 123.2	$ 133.1	$ 144.4	$ 161.8	$ 176.5	$ 191.2	$ 207.7	$ 223.8	$ 239.5	$ 263.2	$ 291.4	1b
1c Corporate & Foreign Bonds	$ 149.7	$ 164.1	$ 178.0	$ 201.3	$ 224.8	$ 243.1	$ 256.8	$ 280.6	$ 317.0	$ 354.2	$ 390.4	$ 422.0	1c
1d Mortgages	$ 382.9	$ 412.5	$ 443.2	$ 473.1	$ 525.7	$ 602.4	$ 682.3	$ 742.5	$ 801.5	$ 889.2	$1023.5	$1172.5	1d
1e Corporate Equities*	$ 676.1	$ 806.9	$ 712.4	$ 706.6	$ 824.5	$ 932.5	$ 735.3	$ 519.8	$ 689.2	$ 862.0	$ 809.6	$ 848.3	1e
II. PRIVATE NON-INSURED PENSION FUND HOLDINGS													
2 Total Financial Assets	$89.4	$101.5	$102.4	$110.4	$130.1	$156.1	$134.3	$115.5	$146.8	$171.9	$178.5	$198.6	2
3 Line 2 (adj. **) as % of Line 1	5.2	5.3	5.4	5.6	6.0	6.4	5.7	5.0	5.5	5.5	5.3	5.4	3
4 Equities, as % of Line 1e	7.6	7.6	8.6	9.5	10.8	12.4	12.3	12.2	12.9	12.7	12.6	12.7	4
5 U.S. Securities, as % of Line 1a	0.8	0.9	0.9	0.9	0.7	0.9	1.0	1.2	1.9	2.3	2.8	2.7	5
6 Corp. & Foreign Bonds, as % of Line 1c	17.6	16.5	15.5	14.6	12.7	11.4	11.5	12.1	11.3	10.0	10.8	11.4	6
7 Mortgages, as % of Line 1d	1.1	1.0	0.9	0.9	0.7	0.4	0.4	0.3	0.3	0.3	0.3	0.3	7

*[Footnotes are on last page.]

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	Line
III. STATE & LOCAL PENSION FUND HOLDINGS													
8 Total Financial Assets	$42.6	$48.0	$53.2	$60.3	$69.0	$80.6	$84.7	$88.0	$104.8	$120.6	$132.6	$153.0	8
9 Line 8, as % of Line 1	2.6	2.6	3.0	3.2	3.3	3.4	3.7	4.0	4.0	4.0	4.1	4.3	9
10 Equities, as % of Line 1e	0.6	0.7	1.0	1.4	1.9	2.4	2.7	3.2	3.5	3.5	3.7	3.9	10
11 U.S. Securities, as % of Line 1a	2.4	2.3	2.2	1.9	1.4	1.4	1.4	1.3	1.4	1.7	2.3	2.8	11
12 State & Locals, as % of Line 1b	2.1	1.9	1.7	1.4	1.4	1.1	0.9	0.5	0.8	1.4	1.3	1.4	12
13 Corp. & Foreign Bonds, as % of Line 1c	16.0	16.2	17.2	17.4	17.3	17.8	18.8	19.6	19.5	18.9	18.6	19.3	13
14 Mortgages, as % of Line 1d	1.3	1.3	1.3	1.2	1.2	1.1	1.0	1.0	0.9	0.9	0.8	0.7	14

Table 1, p. 2

Table 1, p. 3	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	Line
IV. TOTAL STATE, LOCAL, & PRIVATE NON-INSURED PENSION HOLDINGS***													
15 Total Financial Assets	$132.0	$149.5	$155.6	$170.7	$199.1	$236.7	$219.0	$203.5	$251.6	$292.5	$311.1	$351.6	15
16 Line 15 (adj.**) as % of Line 1	7.8	7.9	8.4	8.8	9.2	9.9	9.4	9.0	9.5	9.6	9.5	9.7	16
17 Equities, as % of Line 1e	8.1	8.3	9.6	10.9	12.6	14.7	15.1	15.3	16.4	16.2	16.3	16.6	17
18 U.S. Securities, as % of Line 1a	3.1	3.2	3.1	2.8	2.2	2.4	2.4	2.6	3.3	4.0	5.0	5.5	18
19 State & Locals, as % of Line 1b	2.1	1.9	1.7	1.4	1.4	1.1	0.9	0.5	0.8	1.4	1.3	1.4	19
20 Corp. & Foreign Bonds, as % of Line 1c	33.6	32.7	32.7	32.0	30.1	29.1	30.3	31.7	30.8	29.0	29.4	30.7	20
21 Mortgages, as % of Line 1d	2.4	2.3	2.2	2.1	1.9	1.5	1.4	1.3	1.2	1.2	1.1	1.0	21

* This figure excludes open-end investment companies, intercorporate holdings, and closely-held stock. All figures are the FRB's except for closely-held stock, which is from SEC, Statistical Bulletin, July 1979, p. 13. For note about sources of data, see next page.

** For this line's comparison with Line 1, Total Bonds, Equities and Mortgages, the pension assets have been reduced slightly to exclude "miscellaneous assets." The excluded sum was largest in 1967; and the largest figure that year was 4.7% of total assets of private non-insured funds. No data on public funds' "miscellaneous" assets are available, so no deduction was made from Line 9.

Cash has not been excluded, because in such large measure it is a temporary holding awaiting investment in bonds, equities and mortgages, and so for present purposes seemed properly included.

***For note on insured pension reserves, see next page.

Note on Insured Pension Plans

Life insurance companies held $119.110 billion in reserves for pension plans, as of end-1978. No breakdown of that sum into categories of investments is available, even in terms of rough magnitudes, as about 85% of these insured pension reserves are in general accounts mingled with other insurance reserves.

Of the $119 billion, $19.3 billion were held in separate accounts for pension plans. And on $15 billion of that sum, a breakdown into categories of investments is available:

	$	% of Separate Account Holdings
Common stock	$10,295	66.2%
Publicly-traded bonds	895	5.8
Private debt	1,081	6.9
Real estate	1,067	6.9
Mortgages	23	0.1
Short-term investments	728	4.7
Miscellaneous	1,467	9.4

The asset categorization of the general accounts would differ greatly from the categorization within the separate accounts. For example, as of end-1978, instead of the separate accounts' 66% in equities, total life insurance assets of $390 billion included only 9.1% ($35.5 billion) in common stock.

Source: Life Insurance Fact Book, 1979, pp. 52, 54, 69; and American Council of Life Insurance, Washington, D. C.

Note on Sources of Data

This table relies mainly on the Federal Reserve Board Flow of Funds, rather than the SEC Statistical Bulletin, because the FRB data are integrated and include data understandably not reported by the SEC, such as outstanding amounts of U.S. and state and local securities, corporate bonds, and mortgages. However, anyone comparing the two sources cannot help being troubled. As I understand it, the SEC's pension data rest on a survey of funds holding about 50% of private non-insured assets. The FRB relies in turn on the SEC data, adjusted to integrate with other data. But the adjustments or other causes lead to striking differences, as large as 50%, in identical items.

With all the use made of these data and our pride in our statistical sophistication, we should improve the integration between FRB and SEC data on identical items, or at least disclose more fully why substantial differences exist.

Table 1, p. 4

Historical Risk Premium Evidence, Annualized Ten-Year Rates of Return

Institutional Data Division

Ten-Year Time Period	S & P Bond Index	25% Stocks	75% Stocks	S & P Stock Index
1900 Through 1909	4.5%	5.9%	8.3%	9.3%
1901 Through 1910	4.3	5.2	6.5	6.9
1902 Through 1911	4.2	4.7	5.4	5.4
1903 Through 1912	4.2	4.7	5.3	5.3
1904 Through 1913	4.3	5.1	6.4	6.8
1905 Through 1914	3.8	3.9	3.7	3.4
1906 Through 1915	4.0	4.3	4.3	4.2
1907 Through 1916	4.4	4.7	5.0	5.0
1908 Through 1917	4.1	4.6	5.5	5.7
1909 Through 1918	3.6	3.8	4.0	4.0
1910 Through 1919	3.1	3.5	4.1	4.3
1911 Through 1920	2.9	3.1	3.2	3.1
1912 Through 1921	4.0	4.1	3.9	3.7
1913 Through 1922	4.6	5.0	5.5	5.6
1914 Through 1923	4.7	5.4	6.3	6.6
1915 Through 1924	5.1	6.4	8.7	9.7
1916 Through 1925	5.1	6.3	8.3	9.2
1917 Through 1926	5.2	6.4	8.6	9.5
1918 Through 1927	6.5	8.8	13.2	15.3
1919 Through 1928	6.1	9.2	15.0	17.7
1920 Through 1929	6.4	8.7	12.8	14.6
1921 Through 1930	7.0	8.9	12.0	13.2
1922 Through 1931	5.2	6.1	6.7	6.3
1923 Through 1932	5.1	5.2	4.0	2.8
1924 Through 1933	5.7	6.7	7.2	6.7
1925 Through 1934	6.3	6.5	5.4	4.0
1926 Through 1935	6.6	7.2	6.7	5.7
1927 Through 1936	6.6	7.7	8.2	7.6
1928 Through 1937	6.2	5.6	2.6	0.1
1929 Through 1938	6.6	5.6	1.9	(0.8)
1930 Through 1939	6.8	5.9	2.5	(0.1)
1931 Through 1940	6.5	6.0	3.6	1.6
1932 Through 1941	7.0	7.3	6.8	6.0
1933 Through 1942	6.3	7.5	8.8	8.9
1934 Through 1943	5.7	6.5	7.0	6.8
1935 Through 1944	4.9	6.3	8.4	8.9
1936 Through 1945	4.4	5.7	7.6	8.1
1937 Through 1946	3.9	4.4	4.6	4.2
1938 Through 1947	3.4	5.1	8.0	9.2
1939 Through 1948	3.2	4.3	6.1	6.8
1940 Through 1949	3.3	4.8	7.5	8.6
1941 Through 1950	3.1	5.7	10.5	12.7
1942 Through 1951	2.5	6.2	13.1	16.5
1943 Through 1952	2.4	6.0	13.0	16.3
1944 Through 1953	2.4	5.4	10.9	13.6

Copyright permission, see p. 128, supra.

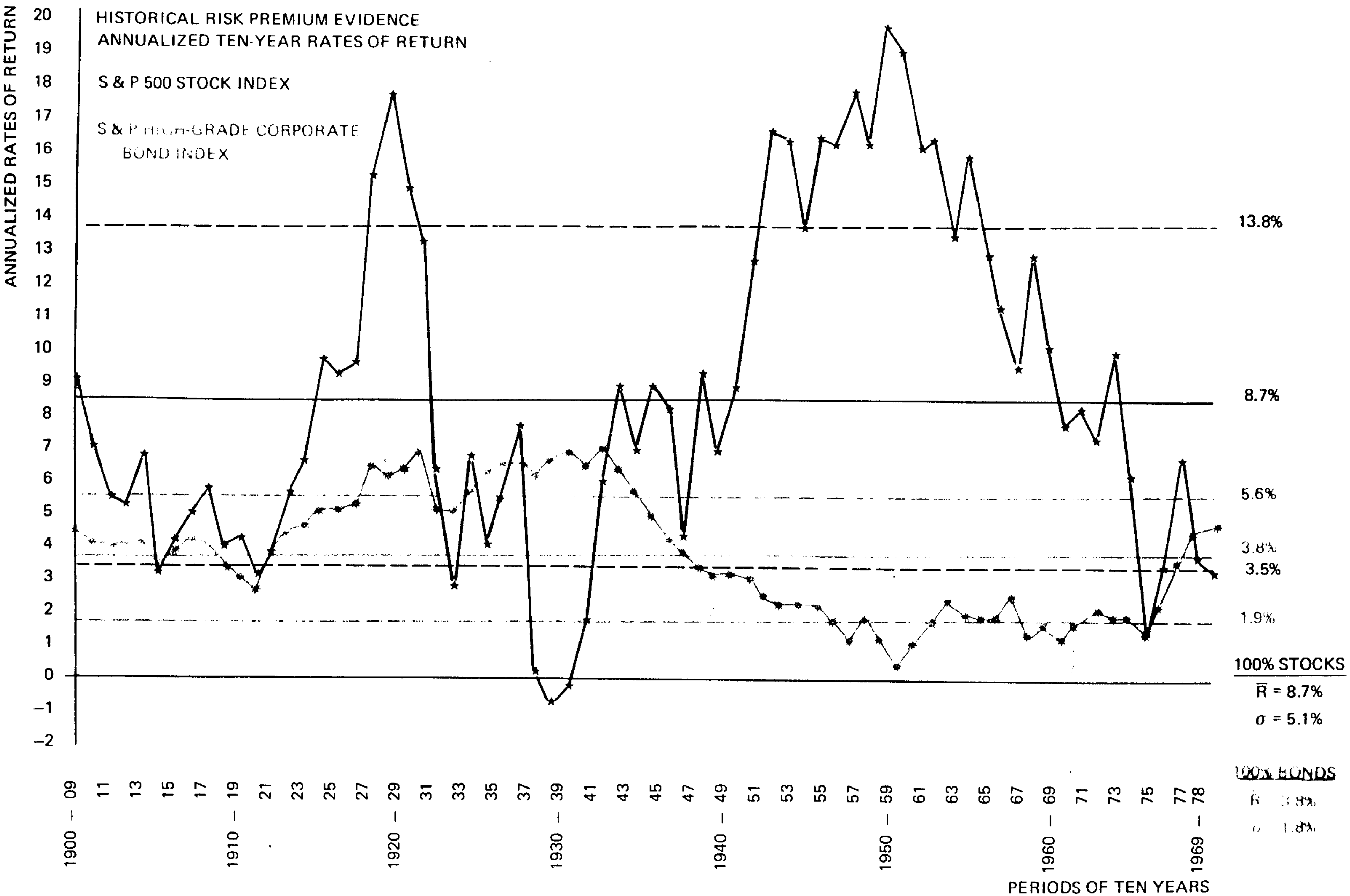
Institutional Data Division

Ten-Year Time Periods, Continued

	S & P Bond Index	25% Stocks	75% Stocks	S & P Stock Index
1945 Through 1954	2.4%	6.1%	13.1%	16.3%
1946 Through 1955	1.9	5.7	12.7	16.0
1947 Through 1956	1.1	5.4	13.7	17.7
1948 Through 1957	1.9	5.6	12.6	15.9
1949 Through 1958	1.1	6.0	15.2	19.5
1950 Through 1959	0.3	5.3	14.6	18.9
1951 Through 1960	1.0	5.1	12.5	15.9
1952 Through 1961	1.6	5.6	12.9	16.2
1953 Through 1962	2.1	5.3	10.9	13.3
1954 Through 1963	2.0	5.8	12.7	15.7
1955 Through 1964	1.9	5.0	10.3	12.7
1956 Through 1965	1.9	4.4	9.0	11.0
1957 Through 1966	2.5	4.4	7.7	9.1
1958 Through 1967	1.3	4.4	10.1	12.6
1959 Through 1968	1.6	3.9	8.0	9.8
1960 Through 1969	1.1	2.9	6.2	7.7
1961 Through 1970	1.6	3.4	6.6	8.0
1962 Through 1971	2.0	3.4	5.9	6.9
1963 Through 1972	1.9	4.0	7.9	9.8
1964 Through 1973	1.9	3.0	5.1	5.9
1965 Through 1974	1.3	1.5	1.5	1.2
1966 Through 1975	2.3	2.8	3.3	3.3
1967 Through 1976	3.7	4.7	6.1	6.6
1968 Through 1977	4.5	4.5	4.0	3.5
1969 Through 1978	4.6	4.4	3.7	3.1

April 19, 1979

Copyright permission, see p. 128, supra.

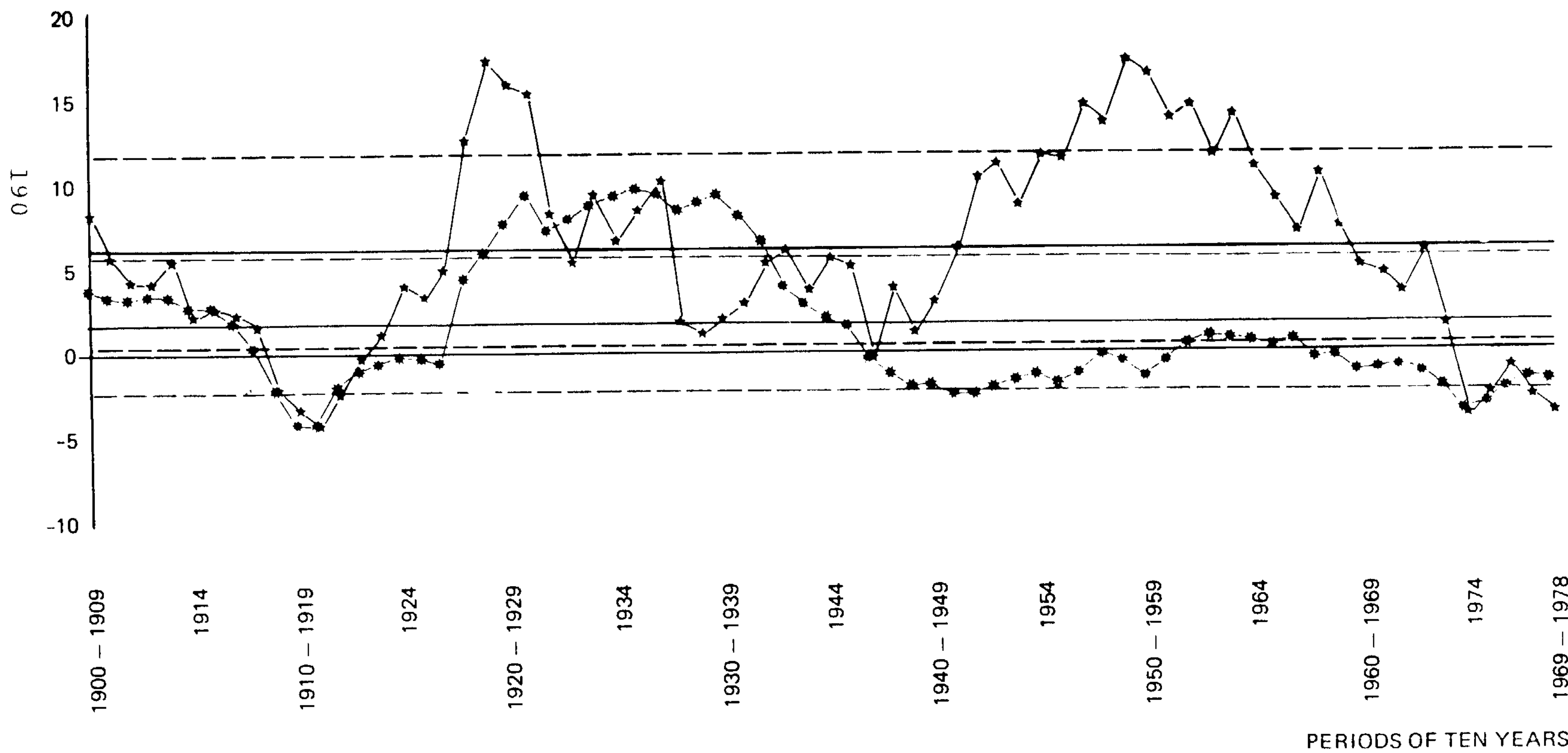


Copyright permission, see p. 128, supra.

Chart 2

HISTORICAL RETURNS ADJUSTED FOR INFLATION
ANNUALIZED TEN-YEAR RATES OF RETURN

S & P 500 STOCK INDEX
S & P HIGH-GRADE CORPORATE BOND INDEX

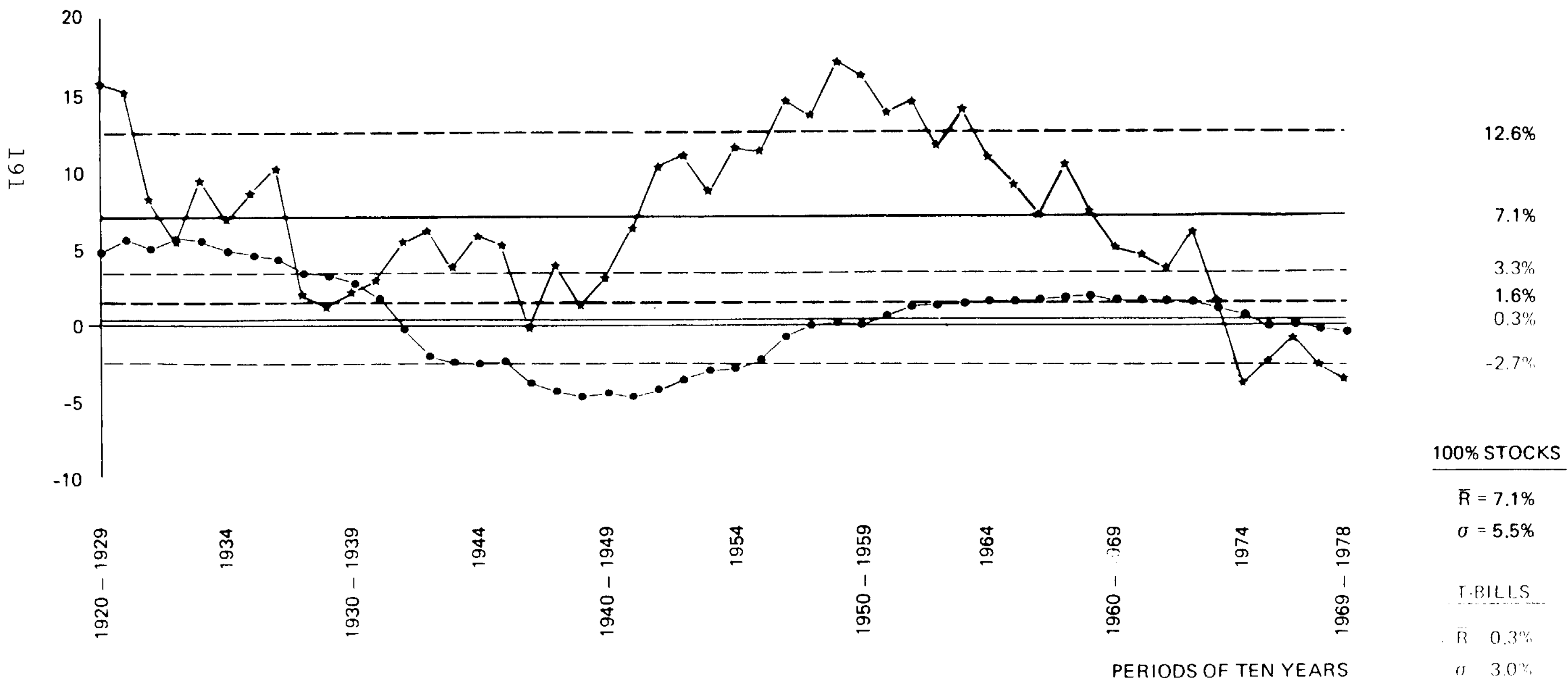


Copyright permission, see p. 128, supra.

Chart 3

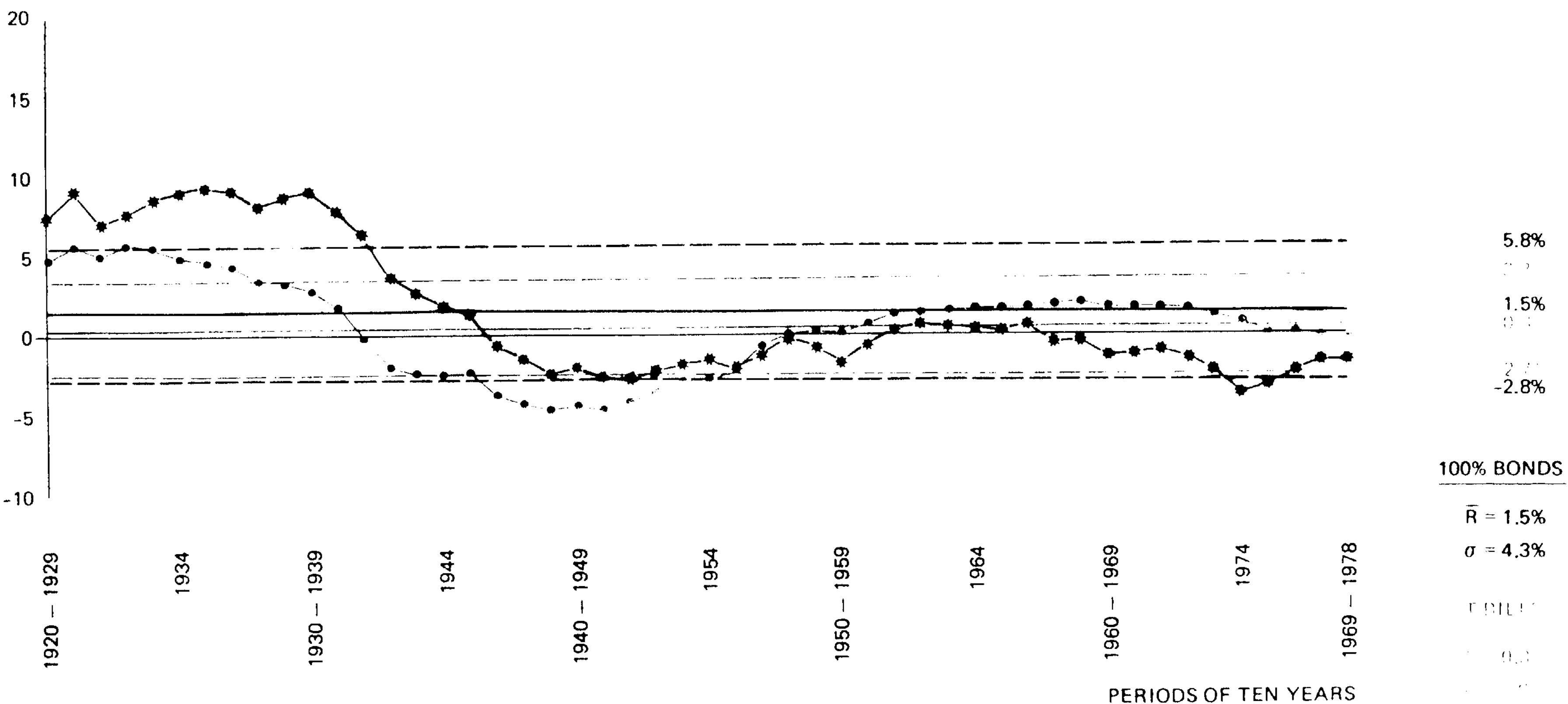
HISTORICAL RETURNS ADJUSTED FOR INFLATION
ANNUALIZED TEN-YEAR RATES OF RETURN

S & P 500 STOCK INDEX
TREASURY BILLS



Copyright permission, see p. 128, supra.

Chart 4



Copyright permission, see. p. 128, supra.

Table 3 Mortgage Holdings of 10 Large (10 of the 11 largest) Building and Construction Trades Union Pension Funds

	NEBF*	Boiler-maker--Black-smith	IBEW-* Members	Operating Engineers 302 & 612	Laborer's Illinois	Sheet Metal Workers National Fund	*Carpenters Detroit	Construction Laborers of S. Calif.	Ohio Carpenters	Painters' National	Total
Total Assets	449,656,001	405,103,573	297,087,235	171,602,256	116,164,986	104,642,423	98,351,437	87,768,513	80,021,248	78,011,030	
Corp. Bonds and Notes	13%	29%	13%	23%	15%	12%	26%	4%	29%	36%	21.5%
Stocks Preferred & Common	14%	32%	24%	46%	28%	18%	61%	18%	42%		26.6%
Mortgages Direct	37%	3%	34%	2%		0.2%		57%		13%	15.6%
FNMA	2%	1%	1%		1%	1%	1%		2%	4%	1.5%
GNMA	11%	0.7%	3%	6%	3%	0.9%	2%		3%	3%	4.4%
FHLM	0.8%					0.3%			0.3%	1%	0.3%
FHA			.003%								0.0005%
AFL-CIO MITF										4%	0.2%
ULLICO						1%			4%	5%	0.5%
Other MITF									2%		0.1%
Total Mortgages Indirect	15%	2%	4%	6%	4%	1.3%	3%		7.3%	12%	6.5%
Total Mortgages	52%	5%	36%	8%	4%	1.5%	3%	57%	7.3%	25%	22.1%

Source: Figures based on 1975 5500's

*See footnote on p. 164.

(Compiled by Jas. J. Sullivan, Jr., GULC '80)

Table 4: 19 State Pension Funds' Mortgage Investments (Compiled by Frederick Anderson, GULC '80)

State (and assets in millions)	Year of State or System Report	(1)* U.S. Govts. and Agencies, as % of Assets	(2)* Mortgage-Related Securities, as % of U.S. Govts.	(3) Private Mortgage-Related Securities	(4) Direct Mrtgs. as % of Assets
Alabama Teachers, Employees, Judges $2,590.1	'78	8.1	91.2		0.0
California PERS, STRS $13,772.3	'77	23.7	81.9		8.1
Connecticut (all) $1,439.5	'77	13.7	51.4		0.1
Georgia Teachers, Employees $1,817.6	'78	15.1	11.2		2.2
Illinois Teachers $2201.7	'78	20.4	42.9		1.5
Indiana Public Emps. $510.3	'78	22.8	94.6		0.0
Kansas PERS $591.7	'78	12.4	15.3		0.0
Kentucky Teachers $674.3	'78	43.4	57.5		8.1
Maryland (all) $2,185.3	'78	?	?		2.4

*Footnote at end of table.

Table 4, p. 2

State (and assets in millions)	Year of State or System Report	(1)* U.S. Govts. and Agencies, as % of Assets	(2)* Mortgage-Related Securities, as % of U.S. Govts.	(3) Private Mortgage-Related Securities	(4) Direct Mrtgs. as % of Assets
Michigan (all) $4,598.4	'78	22.4	73.2		6.0
Minnesota (all) $2,634.2	'79	7.9	83		0.0
Mississippi (all) $626.9	'78	28.0	98.9		0.9
New Jersey (all) $5,974.4	'78	7.4	16.4	3.3	0.6
Ohio Teachers School Employees $4,563.0	'78	7.3	38.4		13.6
Tennessee (all) $1,105.0	'78	23.6	0.0		0.9
Texas (all) $4,400.0	'78	18.7	0.3		8.6
Utah (all) $523.3	'77	13.7	58.9		4.2
Washington (all) $2,281.3	'78	26.6	32.4		11.5
Wisconsin (all) $2,030.8	'78	12.5	49.1		9.3

*The figures in column (2) are, in some instances, understated:
For some states or systems, it is not possible to report in column (1) only long-term Governments, as these are sometimes lumped together with T-bills, etc. Thus it would be incorrect to compare one state with another as to proportion of total assets held in U.S. Governments. Even for the key item here, proportion of U.S. Governments which are mortgage-related, caution is in order, since mortgage-related securities are long-term. Thus to the extent that column (1) includes short-term Governments, column (2) may be considerably understated.

The Board is also extremely conscious of its duty to carefully review all proxy material and has expressed its opposition to certain management policies through its shareholder votes. The following revision of a 1977 resolution is currently being considered by the Board as a guide for investment policy and proxy matters:

DRAFT RESOLUTION REGARDING ADDITIONAL INVESTMENT CRITERIA AND THE VOTING OF PROXIES

WHEREAS, the Investment Board recognizes that when performing their duty of investing the trust funds (pension and other funds) for which they are custodian, their primary responsibility is the prudent and responsible investment of the assets of the funds for the economic benefit of the beneficiaries of the funds; and

WHEREAS, it has become increasingly apparent that the standards of prudence and responsibility may, in limited circumstances, be considered in light of the social and environmental policies of the corporation in which the State owns or contemplates owning an investment; and

WHEREAS, investing in an enterprise which is flagrantly violating the law or stubbornly ignoring public policy may constitute implicit endorsement of those policies, and the Investment Board is of the opinion that government may abrogate its duties to its citizens by offering such implicit endorsement; and

WHEREAS, it is the Investment Board's opinion that corporations which do not take the welfare of society and its members into consideration may jeopardize their own financial stability, and, in today's world, risk depreciation of their investment value.

NOW, THEREFORE, BE IT RESOLVED that the following guideline be adopted: Consistent with prudent and responsible investment policy, the Investment Board shall not knowingly invest or maintain holdings in those corporations which are in flagrant violation of the law or in stubborn disregard of the social welfare of society, or do not recognize environmental responsibilities in their corporate actions, and are not taking reasonable steps to overcome the situation; and

BE IT FURTHER RESOLVED that, consistent with prudent and responsible investment policy, all or some of the following measures may be instituted when a corporation is found by the Board to be in violation of the aforementioned guideline:

1. *The Investment Board will discuss the problem with a representative of the corporation in question for the purpose of:*
   a. *Expressing the view that, as a shareholder, the State of Minnesota is opposed to such policies.*
   b. *Being informed as to the progress underway in ameliorating the problem.*
2. *If voting stock in such corporation is held by trust funds administered by the Investment Board, it may be voted in a manner calculated to ameliorate the existing problem.*
   a. *While it is recognized that it is the Investment Board's responsibility to vote all stocks, the Investment Board may solicit recommendations from its staff concerning the manner of voting stock of a corporation in violation of the guidelines set forth above.*
   b. *When deemed necessary to protect the State's interest in the fund and in grave cases, the Investment Board may constitute procedures for a shareholder's proposal for the purpose of committing the corporation toward correcting the policy in question.*
3. *In the instance that no recourse mentioned above is available and/or it is shown that the corporation is not taking steps reasonably calculated to ameliorate the problem in question within a reasonable period of time, the Investment Board may sell the State's investment in the corporation, if sale is consistent with sound investment policy for the affected funds.*

PART II
FORUM PROCEEDINGS*

This section presents questions, answers and comments from the EBRI Policy Forum. It has been reorganized under major topic headings. The full transcript is available from EBRI. The marked copy used to create this section is also available for inspection at the Institute.

INTRODUCTION

MODERATOR FRIEDES:

What we would like to do this afternoon is discuss as many issues, and have as many people participate as we can. I know there is a lot of experience among the group here as to various forms and aspects of this subject, and we would like to get all of your comments and reactions and thoughts.

I've made a list of different topics that we should keep in mind this afternoon. First, the purpose of pension fund investing; second, who does and who should control the assets; third, what kinds of things can or should be done without sacrificing return; fourth, what are the arguments for and against taking a lesser than maximum return; fifth, what involvement by participants is desirable or appropriate. Sixth, is it practical, can it be done, how do we do it: implementation. And seventh, what differences need we recognize between public and private funds.

The first issue is the purpose of the pension fund investing. This morning Roy talked about the purpose being exclusively to assure retirement security. Jim talked about it being exclusively for the benefit of participants as participants. I think those are very close, if not the same thing. Karen talked about having the purpose of pension fund investing be for the benefit of participants not necessarily as participants. And other people have said that the purpose is to assure plan sponsors the lowest possible contributions consistent with the risk desired.

What are your thoughts about what the purposes should be in pension fund investing?

The Legal Framework

MODERATOR FRIEDES:

Do you have some questions? Mr. Glover?

MR. GLOVER:

I am interested in whether or not your position is that a determination can be made to go into some sort of what you call socially sensitive investment, if the determination is to be made at that time or at some later date when a loss does or does not occur?

MR. HUTCHINSON:

My feeling on that issue is the same as it would be on any investment activity, whether it is socially sensitive or not. The fiduciary follows the best course when he develops contemporaneous rationale and support for judgments made at the time the investment activity is undertaken; as opposed to trying to wait until the time when a loss occurs or a challenge is made, and then develops a rationale for the policy.

So, I would clearly take the position that the analysis of the investment, as socially sensitive and yet in the best interests of the plan, within legal standards, should be made at the outset, at the time the investment strategy is developed or the activity is undertaken.

MR. GLOVER:

Doesn't that imply a different rule for a socially sensitive investment and one that could be determined not socially sensitive? For example, if I have two non-union companies, obviously I am going to go for the union company. Now, at that point, am I liable, in your opinion, if I pick the union company over the non-union company, because it is in my best interest?

MR. HUTCHINSON:

Going back to the original point, I don't think that the standards that apply to socially sensitive investments are different from any other type of investment activity: For example, let's take what I call a socially neutral

investment activity. You consider the labor relations practices of the company, and you believe that those labor relations practices impact on their present or future profitability as an operation, in the turmoil they may face. I think that is the time to articulate the basis for your decision, at the outset.

MR. GLOVER:

Except you said that even if no loss occurs, that we may be liable. So, if I pick the two companies and the one that is union comes up with less return than the one that is non-union, and they are both good returns, then you say I may be liable. Then, at that point, aren't they being treated differently?

MR. HUTCHINSON:

I don't believe so, but I am not sure I fully appreciate the distinction you are trying to make.

MR. GLOVER:

Well, the distinction I am trying to make is, that if I incur a loss at the present time, and nobody has ever said anything, you know, the investment advisor said it was a prudent investment, and there was no initial loss, and then a loss occurs, then they say we made some mistakes. But now because I want to take a union one or a non-union one, you are saying even if I don't experience a loss, or possibly the company did better, I could be liable in some way.

MR. HUTCHINSON:

I think I understand the import of your question. There are two different kinds of potential exposure you face, in my opinion.

One is the loss on the investment activity, which if it wasn't a prudent investment -- I am not suggesting it wouldn't have been -- someone could demonstrate that at the time you undertook the investment activity, you didn't behave prudently, that is one kind of loss.

You are suggesting a different kind of loss, where there is no financial loss involved, but you may nonetheless be subject to some legal exposure because you selected, based upon union and non-union characterizations of the companies. That falls into my other category, where you could be found to have violated the solely in the interest test: meaning, were you investing solely for the interests of participants and beneficiaries, or in the interest of one of the parties involved in the collective bargaining process. Even if there is no financial loss involved you could be found to be in violation of a legal standard, and enjoined from future conduct like that. And to be sued and win is not the ultimate victory, sometimes, in this area. The attorney's fees, and other costs and harrassment, in themselves, can

be substantial, even if no financial loss does not occur.

MODERATOR FRIEDES:

Other questions around the table? Paul?

MR. LUND:

Jim, I think your analysis was very helpful. I think it would also be useful to try to relate to the question of who should be making the decisions? Are we dealing with investment decisions that should be made primarily by those who are assuming the investment responsibility, or are we talking about legal judgments, where lawyers ask for an opinion as to whether or not traditional financial loyalty standards are met? Or is it a mixed question? Just how should a plan relate to the question of are they acting properly within the law?

MR. HUTCHINSON:

I think that is a fair question. I don't think that a fiduciary's mode of conduct in this area ought to be any different than it would be in the development of any investment policy. First, you analyze the purposes, objectives and needs of the plan, from your perspective as a sponsor. Employ the kind of financial expertise and assistance that you need to develop a rational investment policy to serve those needs, and then talk to the lawyer. Don't get a lawyer involved in the process too early to tell you what you can't do.

I think it is more helpful to get the sponsor or the sponsor's involvement of collectively bargained plans, for example, the trustee, to try to analyze the needs and objectives of that plan, have available to them the kinds of financial or investment expertise that they would need to call on to develop a rational strategy to serve those needs, and then review it as a matter of legal standards.

I think if you put the legal end first, you really start with the wrong part of the process.

MODERATOR FRIEDES:

Mr. Tower?

MR. TOWER:

In distinguishing between neutral investments, socially sensitive, and socially dictated, what position would a plan be in that decides that investment in companies that are non-union companies or companies that violate OSHA consistently, is of a matter of course, a negative effect in the economic consideration. Are you suggesting that it is necessary to make a case

by case analysis, in determining prudence, or can you make a class distinction and simply say as a matter of course: we have decided that OSHA violators have a likely potential of running into financial trouble because of legal liability?

MR. HUTCHINSON:

I don't see anything unique about that issue. I believe that what the investing fiduciary has to have is some contemporaneous rationale as the basis for investment strategies. Whether that is a case by case rationale, based upon their analysis of the company, its practices, and the financial projections of its future, or whether you are satisfied that there is enough empirical or other evidence available to you on which you can make a class judgement about particular categories of activities. In my opinion that is not a legal question. I think it is a question of the degree of comfort one can develop from the available evidence, which will help you support that determination.

MODERATOR FRIEDES:

Mr. Rifkin?

MR. RIFKIN:

Yes, I would like clarification of terms. Since we assume that all investments affect society, in one way or another, could you please explain to me why the definition that traditional investments, are "socially neutral"?

MR. HUTCHINSON:

Okay, I am not sure -- you are out of my field, in terms of deciding whether investments all affect society. I am not sure I buy that as an assumption. But in any event, assuming that were true, the question is whether investment activity does nothing but analyze traditional financial returns. What I mean by neutrality is neutral in the sense of not in any way overriding the primary purpose of retirement security for the participants and beneficiaries in the plan. Neutrality there meaning traditional financial analysis. Now, you may say in a global sense, traditional financial analysis is all wet. I don't feel capable to debate that point.

MR. SMEDLEY:

If you were to devise a list of companies -- in this case, say, there were anti-union companies which you didn't want the pension fund to invest in -- I gather what you are saying is that for each company on that list you would have to have a rationale for why you were not investing in that company? In other words, if it was not a profitable investment, in spite of

the fact that you have the whole universe of other companies, non-union and union which you would invest in. Obviously, it wouldn't hurt your investment posture.

I think what you are saying, is that it might run into the problem of the loyalty test because it is done for a reason other than for perhaps the participants, but you would have to have a rationale for not investing in those companies. But suppose you have a church group, a fundamentalist church group, and they won't invest in liquor companies, and the liquor industry is very profitable. Do you mean that they could not refuse to invest in a liquor company? Aren't you exaggerating the problems here a little bit?

MR. HUTCHINSON:

Once, again, I think that the key point is to separate out two different notions. One is prudence in financial analysis, and the other is the loyalty test. I think that your observation is very sound, that there are a host of available investments that can fill different kinds of needs, within a client's values, and some contain union and non-union companies, and on that basis, just as a matter of prudence, you could say, we are selecting union companies. Or we will select companies other than tobacco or liquor companies because from a financial point of view, we could construct a portfolio that produces the same level of return for the client, and therefore, prudence isn't an issue.

The proper question is, you are right, a loyalty factor. On that, I am not suggesting that fiduciaries need to develop a list of reasons why every particular company that he chooses not to invest in has been excluded. I am suggesting that you have to make your own determinations, with answers on the legal level if someone suggests at another time that you excluded Company A from investment consideration, primarily because they are non-union, and you don't select non-union investments for this plan. And someone will ask you to articulate how that makes any sense in terms of the participants and beneficiaries retirement needs.

All I am suggesting is that fiduciaries would do well to decide for themselves what level of comfort they want in that area, in terms of their rationale for exclusion.

MR. SMEDLEY:

Wouldn't you agree, for example, that any union that is on strike, or is under boycott, such as J. P. Stevens, Winn-Dixie and so forth, that that in itself constitutes an employer financial problem and is in jeopardy, and could be avoided.

MR. HUTCHINSON:

I think if you have a company where the economic analysis, because of a long strike or a boycott, would suggest that their financial performance is somewhat at risk, you are not even in a social investing area.

MR. BALDWIN:

I am delighted to hear you say that there might be certain considerations that some of us would consider social, rather than financial, which could be classed in the socially neutral category. I am wondering what you used either prior to developing your paper, or what you would use if someone asked you to determine which of the so-to-speak social considerations, i.e., OSHA, pollution control, hiring practices, and what-not, would be those that might fit into the area of socially neutral considerations, as opposed to ones which would need to survive greater tests of their financial relevance?

MR. HUTCHINSON:

That might be the easiest question that has been asked so far because I am totally unqualified to answer it. I suggest that what you have to do is have people with the kinds of financial or economic expertise to provide -- and Roy, I think, takes up that issue in his paper -- the kind of analysis of characterizations and presentations of information that helps you make those decisions. You are not talking law now. If you can reach the point where, as a matter of financial or economic analysis, you can demonstrate that a particular type of activity, whether you like it or not, whether it is socially good or socially bad, affects the performance expectations of the investment, I don't characterize that as social investment.

MR. BALDWIN:

I guess what I am asking is, what would, as a lawyer, satisfy you as to a proper test for that?

MR. HUTCHINSON:

I would have to see what you present. It is an unanswerable question. You could say the aerospace industry, something this country shouldn't be involved in, that it is bad, and set forth some documentation that long-term that program can't go anywhere. I would like to see that.

MS. MARES:

One of the things Jim emphasized in the loyalty standard was the obligation to recognize the interest of the participants in their role as participants. Now, to what extent do you think

that means that we have to consider other common characteristics that participants may have? For example, all the participants may share common religious beliefs, which would indicate certain actions which would be in their interests, as religious preferences, such as adverse interest in alcohol or tobacco, or the fact that they may share common characteristics as participants, as union members?

MR. HUTCHINSON:

I think that to the extent -- again addressing it solely from a point of view of trying to make some predictions about what the present legal standards might mean when that situation is applied to them -- we stray beyond interests that are in some way either directly or indirectly related to the concept of retirement and retirement security, you present a greater problem in terms of the sense of the fiduciary in the context of ERISA. We think that retirement income security is the notion which should drive those that have responsibility for plans. I think that the more directly interests can be tied to the retirement needs of plan participants and beneficiaries, the greater the probability of being supported under present legal standards.

What will happen when you get very collective, generalized characteristics of the population, that are totally unrelated to retirement needs, I am not sure. I just suggest that the farther down that range you go, given the articulated purpose behind ERISA, and the kinds of standards that apply to plan fiduciaries in investing plan assets for the retirement income security of participants, the greater the fiduciary risk.

MR. ROMIG:

Before asking my question, allow me to congratulate EBRI on what appears so far to be a very excellent forum with papers of the very highest caliber. I am very impressed with the participants here in this room.

My question for Mr. Hutchinson relates to his analysis of the exclusive purpose rule of ERISA. In your paper, as I read it, you generally conclude that this rule is not intended to cover investments, but rather only to cover the expenditure of plan funds. Since this is somewhat of a tentative conclusion, certainly one not tested in the courts yet, is it not possible that a plan trustee, who setting policy and making investments ignores this rule, might be violating the more fundamental prudent man test?

MR. HUTCHINSON:

Mike, I really don't think it is helpful to try to take other portions of the statute, like the solely in the interest

test or the exclusive purpose test, the prohibited transaction rules, and essentially fail to deal with an analysis of them by rolling them back into the prudence test.

I don't mean to be argumentative with you, but I think it is more helpful to try to take each one to them and decide what it means, even though I think in some cases, where the courts either don't want, for technical reasons or other reasons, to wrestle with a difficult interpretation of things like prohibited transactions or the exclusive test, they may fall to prudence as an easy way out. And I think we say that in our paper, that we have got to be aware of that. On the exclusive preference test, I thought that we were cautious enough to indicate that that could be interpreted the other way, meaning an independent, additional test on investment activity, in that all investment activity would have to be justified as serving the delivery of retirement benefits. However, you are correct to say that the courts haven't passed on that question yet. I think interpreting the structure of the statute, and the use of that provision by the courts today, suggests that a likely interpretation is that it was a rule meant to constrain the use and dispersion of plan assets, as opposed to investment activity.

MR. SMART:

I would like to go back to your answer, Jim, to Mr. Glover's question about whether all things being financially the same. If the investment manager were to execute a choice because it was a union or non-union company, I think your response was that potentially there could be some liability for the social ramifications of that investment manager's action. Correct me if I am putting words in your mouth. My question would be if, under the way in which investments are being done now, in a traditional sense, if a manager is not making any kind of a determination in terms of whether it is socially in the interests of beneficiaries, could he be held liable for negligence?

MR. HUTCHINSON:

That is a notion that is developed in Karen's paper, that I found probably the most intriguing point that she raised. That is, whether there is some appropriate obligation or affirmative duty, when involved in a situation between economically comparable investment activities, to seek out an investment activity that might have some beneficial and direct effect to the beneficiaries.

I find it an intriguing notion --

MR. SMART:

I think there is a flip side to that, also, that it could have a detrimental effect to the beneficiaries, were it to be excluded.

MR. HUTCHINSON:

That is a fair statement. Either there is a potential beneficial effect, if ignored, or there is a potential negative effect, if it is ignored. I think it is an intriguing notion and it has some appeal. I don't mean that in a prejorative sense, because when you are talking prudence and loyalty, and what is good and right, the courts do some interesting things at times. However, looking at where the law came from in this area, prior precedents, I don't find that notion well articulated in the law: this affirmative obligation. In addition, I think it doesn't take into account a part of ERISA, and I hate to be technical and structural, but a lot of the way the fiduciary standards for ERISA are developed suggests that a fiduciary's conduct and his responsibility is in many ways defined by his area of discretion and authority.

What I mean is that you could have an individual who would be a fiduciary for investment purposes, whose area of discretion was limited to an equity portfolio, as part of the assets of the plan, and executing a strategy which is reasonably well defined. For instance, risk and return assessment of the characteristics of investments involved. To suggest that that fiduciary could be remiss in not considering local mortgages, which would be as beneficial in a return sense to the fund, and possibly more directly in the interest of the participants in the fund, I think strains that structural development in the statute which essentially says that your area of fiduciary responsibility is limited to your area of discretion which makes you a fiduciary.

That is a very technical argument, but it is there and it is real. Until you get a fiduciary in the area of co-fiduciary responsibility, where he actively participates in a decision outside his area of discretion, and until he becomes aware of the violations and does nothing about it or has knowledge of the situation that ought to require corrective action, until you get to that point, I don't think that affirmative notion finds a great deal of support in present law.

I am not suggesting that it shouldn't be there, or that it couldn't be. I just think I don't find a great deal of support for it at this point.

MODERATOR FRIEDES:

I see two more questions for you, Jim. Then, we can let you off the hook here.

MR. TOWER:

On the question of loyalty, assuming that ERISA's standard has its roots in the common law, we are looking at more than

conflict of interest when we classify investments that are designed to benefit third parties, that are totally distinct from either of the plan sponsors in the collective bargaining situation where you do not have presentation of the conflict of interest or any defense of the conflict of interest.

MR. HUTCHINSON:

I guess the easiest response to that is that if Congress only meant to deal with direct conflict of interest problems, as they have very specifically in the prohibited transaction rule, then there would be no need for the solely in the interest test. So, merely as a matter of lawyering, when you look at a law, it has a number of provisions in it. You have to assume, as a matter of statutory construction, that each provision means something.

MR. TOWER:

Granted, but doesn't the Internal Revenue Code also include the very specific prohibited concept and language?

MR. HUTCHINSON:

Assuming a private foundation, there is a section of the Code under which the regulations developed what they thought that test meant in the investment area. I draw from the notion of ERISA, which has a prudence standard, prohibited transaction rules, and the solely in the interest test, that there must be something meant by that. I am not suggesting to you that that is a close-out bid. As I said to you in the beginning, we are in an area where the courts have not resolved the issue. I think the arguments that you make, generally, can be and probably will be made in this context. I don't think that there is any certainty in terms of the resolution of the issue.

What I tried to do in my paper was to lay out the kinds of considerations that people in an investment position ought to consider, in trying to deal with the issues of how to invest.

MR. TOWER:

Again, looking at the prohibited transaction section of ERISA, there is nothing to suggest that Congress meant the prohibited transaction section by itself, is a universe of the situations. Surely, there are others. I can think of a few that are not specifically listed.

MR. HUTCHINSON:

I agree. Quite frankly, I support your statement because I think you have come to the conclusion that I did. There are other standards in the statute, like solely in the interest.

MODERATOR FRIEDES:

Mr. Glover?

MR. GLOVER:

Yes. You said follow the objectives of the plan, and so I am going to pose a question here and get your response to it.

If we put in, as one of the objectives of the plan, to invest in union companies, using prudent judgment, when all other things are equal, is that a valid objective of the plan?

MR. HUTCHINSON:

I don't know the answer to that question, and I am not being facetious. I think that is the purpose when you pose a question, that one has to decide. I suggest, though, that in putting in that objective there is one small preliminary you should always talk about when you develop plan objectives. That is, you can write a plan's options so that it can permit the investing fiduciary to take certain sorts of actions, but that provision in the plan cannot override the general statutory rules, such as prudence and acting solely in the interest of participants. Therefore, I suggest that fiduciaries that are involved in investment activity, who want to try socially sensitive investment policies, should clearly have plan documents which would permit that. But, there is the overriding question, you can't articulate a policy in a plan document that is in violation of the statutes, generally.

MODERATOR FRIEDES:

Your subject is very popular. We will hear from Mr. Rifkin and Mr. Berger, and I would like to go to Professor Schotland.

MR. RIFKIN:

I want to get a clarification on socially sensitive. If we have a company A and company B that have the same return. Company A sports an anti-union policy; Company B sports a pro-union policy. Wouldn't both of them be considered socially sensitive investments, depending on who was making the judgment? In other words, there would be people who would think that Company A was a socially sensitive investment, and others would think, because of their own interests, that Company B is the socially sensitive investment? So, aren't both of them, in fact all investments, socially sensitive, at least in that category, the same return?

MR. HUTCHINSON:

I am afraid I don't agree. The categorization that I tried to develop, and I confessed at the outset that I don't find a place in the law where it is written today. It was an attempt

by us to try to develop categories that would be a meaningful way to analyze a whole range of activities in this area. I hate to belabor the point, but when you are looking at any investment activity you have got to look at it at least in two different ways. One is prudence, and you have clearly articulated that issue. Equal investment, equal return, and I will assume for all other purposes, equal investment characteristics. I don't think that is a question of prudence anymore. You have resolved that issue.

The second question then becomes whether the investment activity is undertaken solely in the interest of plan participants and beneficiaries, and can be defended as such. You are correct, depending upon who the plan's sponsor is, that issue may be viewed in different ways. All I am suggesting is, you had better have a rationale relating what your position is, for the interest of the plan participants and beneficiaries.

MODERATOR FRIEDES:

Mr. Berger?

MR. BERGER:

I would like to make a brief comment and ask a question. I think that this whole area is made more difficult by political characterizations and imagery, and that it is helpful to first proceed with the kind of analysis that you made. It may be that an awful lot of reasons get resolved in that kind of analysis, without satisfying our desires to politically categorize what we are doing. Having said that, it seems to me your analysis, however, has subsumed an overriding and continuing major issue. And I would like to see how you would place it in your analysis: that is the flow of contributions to the plan. It is clear, isn't it, that if the contributions were to cease or be reduced with respect to a plan, that the economic interest of the participants might be adversely affected.

Now, you have situations where industry may be in economic difficulties, so that an issue arises as to whether it is appropriate for the plan to give -- certainly you can deal with the prohibited transactions, put that aside for the moment -- economic support to a segment of the industry. Or, it appears that it might be possible to maintain the flow of contributions if you invested in a union employer, or an employer that is in the region. Or, in a situation where a city is deteriorating, if it continues to deteriorate, the work covered by the particular plan, whatever it may be, may become reduced.

Now, my question relates to how you fit into your analysis the issue of whether you either have an obligation or a right to consider the impact of the particular investments on the flow of contributions to the plan?

MR. HUTCHINSON:

That is a tough question. A question which I will characterize, in my opinion, as the Withers Case, the City of New York essentially. In such a case considerations of the financial viability of a contributor to a plan affected that court's judgment as to whether the investment activity was appropriate or not. A couple of things. One, I think you would say that putting to one side the prohibited transactions could be very difficult.

Secondly, when you are dealing with the two part analysis that I suggest, meaning prudence and solely in the interest of participants, I think both of them are very much affected by the financial stability of the plan itself, and therefore, the financial stability of those contributors.

I am troubled, and I guess it is because I don't know the answer, whether a court will decide that the range of considerations that a fiduciary may take into account, as the fiduciary for New York did and with the federal court's support, outside the ERISA context, whether that is permissible within ERISA standards. I have doubts about that. Even though the City of New York's retirement program was a non-ERISA plan, they saw fit, and I think on good advice, to seek a specific exemption, even from the Section 401 test of the Internal Revenue Code, which talks about investment for the exclusive benefit of the participants and beneficiaries. So, they were troubled with even that more generic test, it might not be met without a statutory exemption.

Now, I don't know how that is going to come out. I think that there is a fair amount of risk involved in considering one or two-tier removed financial considerations of the sponsor, and I think one of the mechanical questions, talking about private plans, are in fact the prohibited transaction rules. I am not saying whether we should keep them or not, but I think there is a present legal impediment for much of that kind of activity.

The Legal Setting and Risk

MR. SMEDLEY: Far removed is the question from when Jim Hutchinson was talking, his question who stands at risk. It seems to me that, for example, where you have collective bargaining with a single employer defined benefit plan and in the bargaining agreement you negotiate with certain investment requirements, you create a special situation. Generally the employer provides a level of benefits, so even if the investments don't turn out well, participants do not suffer. The employer is responsible for a given level of benefits. So it seems to me, and maybe you agree, that the courts would probably apply different criteria of prudence to a situation where you had a level of benefits guaranteed and you set special investment criteria through collective bargaining, than in a case where you had a defined contribution plan where the level of risk and so forth is entirely different and rests with each employee. Don't you think there would be a legal interpretation that would be different in regard to prudence in the two cases?

MR. HUTCHINSON: As we tried to point out in our paper, I think that there's a distinct possibility that the courts would do just that. But I don't know anything presently in the statute or in the court decisions or regulations which gives me a great deal of comfort to predict that with any certainty. You're right, the company by in large is at risk to provide a defined benefit through collective bargaining. And, the company is at risk to figure out how to make the money to do that. The only qualifier I put on it is that you just look at more than whether they promise to do it, but also what their financial ability to do it is as well. And if a company were in a strong financial position with a well funded plan but it didn't have a great deal of unfunded past service liabilities involved, that might be one set of facts a court would look at. But even in the defined benefit area, if you're talking about a different company that doesn't have a corporate balance sheet that's quite so strong, where its pension cost and contribution are a significant part of its annual activities, and where the vested unfunded liabilities in the account are rather high, they might take a more jaundiced look at whether that was prudent or not to put at risk employee money for money standing behind the benefit payment.

MR. SMEDLEY: The assumption there, Jim, that you're making is that the investment necessarily would cost the company money. That's not necessarily so.

MR. HUTCHINSON: Oh, it may not. We're talking about a hindsight test if it does.

MR. SMEDLEY: So wouldn't the legal test of prudence be if the determination on the social investment was carefully thought out and was an investment that was comfortable at the time it was made in terms of investment return? In other words, it was prudently made at the time. Any investment, no matter how carefully made, whether it's social or not, could turn out bad. The test is not retrospectively looking back as to whether it was prudent or not, the test is whether it was made in a prudent manner at the time it was made.

MR. HUTCHINSON: I agree with that.

MR. SMEDLEY: All right.

MR. HUTCHINSON: I don't adopt the hindsight test. I think in the real world where we all may wind up in court some day, you can't make a court ignore experience. But the fact of the matter is that the legal standard appears to be one of contemporaneous decision making as opposed to result.

MR. FRIEDES: Karen.

MS. FERGUSON: Actually, Mr. Smedley, you said very much what I was going to say. That the prudence rule--responding to George Lingua--the prudence rule was put in there to protect fudiciaries. And basically what it says is that if you do follow careful procedures and are diligent, as long as you're not stupid or negligent, we'll judge you on your procedures at the time. This test is only, in a sense, an extemporaneous test. Certainly the Labor Department's recent regulation reinforces that. I don't think there's ever been any question that in truth that language is meant to protect you. And if you do what other reasonable investors would do under those circumstances, you have met the prudence test.

MR. SCHOTLAND: I'm a little surprised by Karen's statement that the prudence rule exists to protect the money managers, the trustees. I thought it was like a lot of other rules we have to try to remind judges of the dangers of second guessing, that judges don't know everything, and that they've got to defer in some measure running corporations to that is called the business judgment and in running money to what is called the prudent investment decision. I thought it also would have presumably never appeared in a body of law so totally beneficiary oriented as individual trust law at least with Austin Wakeman Scott presiding over it, which he did, and it just wouldn't have stayed there, if it were to the benefit of trustees without being there by 100 percent to the benefit of beneficiaries. I think it's there also to remind the trustees against wild experimentation or excentricity or various other things that has its problems of

pushing people into a herd. But it is not there in order to protect the trustees.

MR. BARBER: I can't resist that, Roy. There's no doubt that the very fact that you have direct penalties associated with breach of who is to share responsibilities that at least one of the purposes was to further protect beneficiaries. But at least as I understand just from looking back and trying to understand the legislative history of ERISA, that that was only one of the reasons for that prudence provision. And certainly the language changed from the common law language what a prudent man is and what the new prudent standard is which is essentially a new standard. And, as long as you can demonstrate you're doing what someone else is doing and what the rest of the pack is doing, that clearly is a protection for the money manager or fudiciary as well as is another level of protection for the beneficiaries.

MR. FRIEDES: I'd like to hear from Vance Anderson as a draftor if you can help us here.

MR. ANDERSON: I guess I'd like to observe that I understand Roy's surprise that the fudiciary standards provision might be viewed as some benefit to a fudiciary. While it's true that I think that the record would be clear that both the Senate and the House, in passing ERISA and in partic3lar the fudiciary requirements, the prudence standard, felt that they were imposing some straight jacket, if you will, or some standard of liability on those who deal with plan assets.

I must say Roy, that I'm not quite as surprised as you might be to hear that because I have in fact heard that some fudiciaries take comfort in the fudiciary standards provision. And where I've heard that sentiment expressed it's because it puts them in a posture where they can clearly insulate themselves from some of the political winds that blow around on this question of how capital would be best allocated to meet the various purposes. It gives them clear guidance. They can in fact point to the statute and direct attention to what they perceive to be their clear cut obligations to make investment decisions on behalf of the plan and on the behalf of the beneficiaries and participants. Now I think that Congress may have been maligned a bit in some of the motivations that have been ascribed to them in moving to enact a federal fudiciary standard. I must say, Karen, in all honesty I would have a great deal of difficulty supporting the proposition that either the Senate or the House was consciously attempting to leverage out the position of institutional money managers in establishing the standards there.

MS. FERGUSON: I don't think I said that.

MR. ANDERSON: Well, if your position, as I recall, was --

MS, FERGUSON: Being endowed with the Taft Hartley averages.

MR. ANDERSON: The idea was to disadvantage the enlightened damager.

MS. FERGUSON: That's right.

MR. ANDERSON: I think if you have recourse to the record on ERISA that you'll find that there were in fact proposals before both the Senate and the House that would have accomplished that, and that they were in fact rejected; the whole idea of establishing capital requirements for those who might serve as trustees were rejected although it was proposed. As a matter of fact, I think you'd find that the idea that we would have a professional trustee standard was in fact rejected and went with a slightly lesser standard, if you want to call it that, than knowledgeable trustee a clear invitation to amateurs who possess some requisite, as you used the term enlightment, to serve in that capacity.

MS. FERGUSON: I think, Vance, I'd like to make one comment and then continue this privately.

(Laughter)

MR. ANDERSON: As you wish.

MS. FERGUSON: The original, as you said, fudiciary standard was drafted considerably in advance of the major deliberations on ERISA and considerably before your participation in those deliberations. And that standard remained relatively unchanged throughout the laws history. And my information predates that later state.

MR. ANDERSON: I'm always prepared to be corrected on my memory of events, even those that I may have participated in.

MR. FRIEDES: Mr. Bianco.

MR. BIANCO: Peter, I wanted to address the question of risk. We alluded earlier to the concept of setting investment objectives and designing a program of investment policy such that the reward risk relationship has been properly established. It's a doable phenomena, and I think they were doing it every day. It seems that ERISA never called for maximum investment returns, but instead calls for adequate investment earnings such that the plan can be maintained on an actuarialy sound basis. Given the reward-risk structure that one can define for a given plan, it would strike me that it might be suitable to include some of these investments that these people describe provided, of course, that the risk-reward restraints have been satisfied. This would not allow accepting reduced returns with increased risk. There's a little bit of appeal to some of the investments being discussed since there's an element of diversification added, which is a desireable property in the aggregate of investments. So I submit that the real issue is to properly establish the appropriate risk levels that you're trying to achieve and

then live within that. And if, in fact, some of these social investments can be so accommodated, fine.

There's a flip side, too, which intrigues me, and that's the use of foreign investments. With foreign investments there's no limit to diversification. However, they may be socially undesireable from the vantage point of, for example, the fact that it's creating job opportunities off shore, et cetera.

So I think there are several aspects to this issue. The element of diversification really hasn't been brought up. The use of risk constraints as a mechanism to deal with the problem ought to be aired. And the use of some of these SBAs, for example, had been mentioned that they're packaging now. These are alternative vehicles which have a lot of social appeal.

The Advocate's Position

THE ADVOCATE'S POSITION

MODERATOR FRIEDES:

I would suggest at this point that we ask questions of Karen only. I know that is not going to be that easy. We should stick to the clarification of what Karen is saying.

MR. LEIBIG:

I am Mike Leibig.

First of all, there is a debate between the two speakers about whether public officials and union representatives represent the participants of plans.

I would just like to say that while I think unions directly speak for the participants, I would very much question whether public officials do. To say that the unions who represent private employees are the true spokesmen of the participants in private plans, but to then say that in public sector plans it is not the unions who represent them but their employers, is highly questionable.

But my main concern, I think, about what Karen said, and maybe with what Barber said also, is a problem that arises when you emphasize the radical and the micro-levels and the macro-levels to such a degree that you aren't able to change. The problem I see with the ERISA rules for instance, is that ERISA goes beyond saying "in the sole interest of the participants." and says specifically which of the participants' interests are supposed to be considered.

Many of the arguments for social investments are for other then the provision of plan benefits. I think that is the hard area of the law in ERISA to break through: to advocate that the interests of the participants should be broadly considered, rather than the narrow aspect of paying benefits.

MS. FERGUSON:

I am saying that you must be concerned that you meet the solely in the interest rule, but there is also the "for the exclusive purpose of paying benefits clause in ERISA."

MR. HUTCHINSON:

These issues are treated in my paper, and I think that question came up this morning. And the question is how the solely in the interest test fits with the exclusive purpose of paying benefits and defraying the reasonable costs of administration. And, what the rules means in the context of investment activity. Let me say, with the caveat that I mentioned earlier this morning, that every time I try to predict what the courts will say I assume that the arguments that have been made, along with every phrase in the statute, to serve some purpose, that it has some meaning. We don't know what that is going to prove, but that is the way we now look at it. With that in mind, we thought there were two possible interpretations. One was that all investment activity had to be rationally and directly related to the direct provision of retirement benefits. At the same time, though, we thought that the context and the way that phrase is used in the passage, and the way it has been used so far by the court, suggests another interpretation. That it is meant to say administration of the trust. That is, when money is first assigned, you have got to do it in such a way that will hold it either to the provision of benefits or defraying the cost of administration, as opposed to being a test over and above prudence and solely in the interest of an investment activity.

MS. FERGUSON:

There was a concern when ERISA was -- a case in -- drafted about trustees who were going to conventions, spending great amounts of fund money, and then spending the day on the beach. My guess is that that provision is very specifically meant to get at that type of problem.

MR. LEIBIG:

I think we have to look at a very specific investment. A union says to a trustee, we feel that you should make this specific investment, and the union makes a very strong case for a number of reasons which are broad. I think in the factual situation what you end up getting, is people saying yes, there may be some vague interest, but it is not an interest of benefits in this plan, so we don't have to consider it.

I think the law will develop, if someone ever makes an adequate, factual case and goes to court, to say that is not so. But the problem, to be realistic, is that Randy and I and other people interested in social investments have to make the case, and have to overcome the argument that is there and that people are relying on.

MS. FERGUSON:

Take Mr. Glover's situation. I think that he would not have that easy a time, although I know he can do it, establishing that the behavior of the companies that will be on his list due to anti-union activities has a direct impact on participants, both active and retired.

PRESENTATION OF MR. RANDY BARBER

You know, I think it is important, first of all, before I discuss specific points that have been raised by a number of people here already, and clearly will be raised later in the day, to put this meeting in a little bit of context.

This is not a socratic dialogue among disinterested parties. I would say that in some ways, this could be akin to a situation of maybe 200 years ago, as the representatives of the American colonists sitting down to the King's privy council, in an attempt to convince them to give up a little bit of power over their fabulously wealthy colony called America.

With all due respect, I would point out that the Employee Benefit Research Institute, itself, was established by some of the major actors in a multi-billion dollar industry, the pension industry. I would think that it would be appropriate, since Mr. Hutchinson pointed out, we have to ask all the questions about whose interests are involved in any particular situation. To ask the question: what are the interests of the people who have established this Institute or who manage these funds? I would suggest that one of the reasons for forming and funding this Institute, and for having a dialogue such as we have today, would be that given the fact that we have institutions here represented that have right now, direct or indirect control over tens of billions, if not hundreds of billions of dollars, that that interest is pretty obvious. If you look at the whole question which has been raised over and over again, about the need for fiduciaries in the broadest definition of that word, to be neutral, that clearly in terms of the economic process and the economic system that neutrality does not exist.

I would simply add that I think those in the investment business would probably agree that the November 19th issue of Pensions and Investments accurately reflected what pension funds really mean. P & I was trying to convince subscribers and advertisers that they reach more financial decision makers than anyone else. P & I wrote: "Pension funds represent an extraordinary opportunity for both financial institutions and for corporations. An opportunity to tap the largest pool of private wealth ever assembled. Capital to create new markets, develop new sources of energy, opportunity for institutions that manage pension assets to divert the private portfolios and explore new areas for investing. There are only a few thousand

decision makers in the financial marketplace. Think of it. Hardly enough to fill the Rose Bowl."

The pension industry is a major industry. It is the largest source of external capital to American industry today. It is not, and I believe cannot be legally separated with whatever fine distinctions you might want to make, in terms of the way the law was drafted -- and parenthetically I would add, who had the major input in the drafting of that law? -- and the direct impact that pension funds have on our economy and on our society.

I believe it is totally impossible for anyone to be neutral about such an important question as the allocation of resources within our society. That is an impossibility, and any one who thinks they can be neutral about that, one way or another, doesn't care about the clothing on their backs, the roof over their head or the food that they eat. It is as simple as that. I also believe that it is actually true that pension fund trustees should be loyal only to the pension fund participants. That debate is one which has not been broached within the financial community or within Congress, within organized labor, or the other more direct representatives or pension fund participants, to an assessment of the relationship between the accumulation and allocation of pension fund assets, and the very nature of economic life within our country.

Capital flow itself, the investment process, is not a neutral process. There are many decisions that are subjective from the point of view that they benefit some group and work to the disadvantage of other groups.

Whenever a company such as U.S. Steel decides to allow its facilities to run down one place in order to maximize its resources in another place, somebody wins; somebody loses. That is a fact of life. Those of you within the pension industry have never tired of telling us that there is no free lunch, which is true, and that there is a fixed stock of resources within our society at any one point in time, over which all of us compete.

Capital is highly mobile, far more mobile than a work force, certainly than a government. Capital, in terms of its investment policy, certainly with respect to the financial institutions that presently control it, seeks to maximize return on the basis of a perceived level of return and to find that summarily, that many things which up to now have been, thanks to Dr. Samuelson and Galbraith, considered as externalities, are finally being plugged into the process.

Nonetheless, when a company makes a decision to put a plant in a particular town, and leave that plant there for 30 years, there is a tremendous intra-structure that goes around it. When that company closes, it is not liable for any of the costs that it imposes on the community, in spite of the fact that that

community has grown very dependent upon that company. Those of you in the investment community -- and I note that we have a number of representatives from the business roundtable here, Chamber of Commerce, National Association of Manufacturers -- are directly involved in political questions that relate to the economic well-being of this country and the economic decisions that this country makes.

I would point, for instance, to the vociferous opposition of NAM, the Business Roundtable, and the Chamger of Commerce, to small pieces of legislation calling for consumer protection and national health insurance. And for instance, those financial institutions that are members of the Business Roundtable and are able to exercise that weight, are doing it not with their own funds, but with the funds of other people, and increasingly through their access to the allocations of retirement capital.

Capital mobility, which is praised within most of these circles, is simply the ability of capital to make its own decision on what it will do and where it will go. I read to you a short statement from James LaFloure, Executive Director of the Wisconsin Investment Board, a $5 billion institution. He says: "Capital is extremely mobile and flows to where it is wanted and rewarded. It is by far the most mobile of the elements of production, which also include labor, land and management. If it is punished by taxation, regulation or other means, it flees. It doesn't vote and it doesn't complain; it just moves to the highest bidder, and always seems to be in short supply to someone. It is an elegantly simple process, with flows dictated by an efficient market system, which I have already alluded to. Intra-national and even international borders are not sufficient barriers. Moreover, it is a very moral process." That is, I would say, a textbook description about the traditional view of capital flow. But, capital mobility is used directly and politically to undermine what some economists would call the soeical weights, unemployment benefits, various kinds of regulations, worker's compensation, et cetera.

Capital mobility, itself, we should keep in mind, is often used to keep unions or the workers off guard; it is used to undermine specific gains that have been made by workers, through their unions, their political actions over decades in this country, or it is used to play one area of the country off against another. We didn't start the vulcanization of states.

Mr. Ernis has very accurately described the process that is going on in terms of the widget company, in which states are already trying to undermine each other in terms of bidding down the possibility of doing business within their state, and ultimately, you are absolutely correct, the only beneficiary is the company who is able to play those two against each other.

This mobility is not only in terms of its control, through pension funds, undemocratic. It also, I would submit, serves to undermine the very democratic process, itself.

Now, why is that important?

It is important because we have moved into -- I used to say, we are moving into, but everyday when you read the newspaper, we have moved into a new economic era. It is an era of increased scarcity. It is an era of increased competition for access to the resources of our society.

The nation's capital markets are simply a way of allocating resources within our society, and I believe that the control and the accountability of the capital allocation process, itself, should be the true issue from which we begin our discussions to-day.

Now, there are several points that have been raised in terms of, for instance, the loyalty, again, of the managers to the participants.

Two years ago I started interviewing individuals in the fin-ancial community, some of whom are in this room today, asking questions such as: does it make any difference to you that here you are sitting in New York? There is the South Bronx. There is clearly a flow of capital from this region, and you, through the individual who has control over the investment of tens of billi-ons of dollars of worker's wages, many of which come from this re-gion, you are participating in the process of undermining this locality.

The individual to whom I spoke, there, shrugged his should-ers and said, "well, in our economy, you have got to let the chips fall where they may. Eventually, people who in Massachu-setts have been greedy at one point and bid up their wages and bid up their taxes and their regulations and lost their jobs to Mississippi, will see the light, and while the people in Mississ-ippi start getting greedy, the folks in Massachusetts will reduce their expectations and ultimately, we are going to get one of those shops from Biloxi to Boston." But that is a long view. That is the process that someone sitting on the 50th floor of a building looking over Central Park, can say with some comfort. The pension participants that we have been discussing might ahve a different view.

Now, I may disagree with Karen Ferguson on a number of is-sues. But, I must point out the resources that access to the business of handling pension funds gives all of you in this room, in terms of defending your own interest. Karen Ferguson, in an office that is just around the corner from me, is receiv-ing hundreds of letters from individual participants a week, who have been losing their pension funds; she is the only person, literally, not figuratively, who is trying to defend and help the individual pension participants in the way she works.

It is incredible when you look at that. Your access to this business has given you power over this process far greater than anyone, including my friends within the labor movement, in terms of affecting this process.

I would say in one instance, my strong disagreement with Karen, at least in a practical sense, is Karen says she disagrees that union representatives and public officials should be vested with the authority to invest the funds of participants. I happen to believe that all pension funds should have elected representatives controlling all of those monies. That until we get to that point, the group of people who are the most accountable in theory and in practice are not corporate appointed trustees, but public officials and union representatives.

Until corporations are willing to accept something like the Landrum Griffin Act, which guarantees internal democracy on the part of union members, I think the argument that somehow unions are less accountable than a corporate appointed trustee is a completely specious argument. Investment managers should be loyal to the participants. There is no question in my mind. There is also no question in my mind that there are far more unanswered questions, than answered ones at this point. I would simply point out that for all of the billions of dollars that are spent each year on pension industry services, people need to start addressing some very sticky questions. No one has given an ounce of thought, and certainly not dedicated any resources to understanding what is the effect on the participants of pension funds, deferred wages and as first savings, back on their present economic security, and even on their ability to collect a pension fund in the future. I cannot give you statistics on that, and you can't give them to me, either. Until you can begin to answer the question of the allocation of worker's deferred wages -- probably the largest single source of savings that individual participant has -- and how those investments are affecting their lives and their futures and their children's futures, then moral legal arguments, moot court arguments like Roy Shotland will be giving us in a minute, ultimately are not particularly useful.

I would say just in addressing Roy, and in giving him the last word, that Roy has a very good heart. He has an excellent mind -- devious at times -- and he is great with the verbage. I would say that the real question to begin asking of Roy is divergent from what? I read in the back that the process from which we are advocating a divergence is one that is ultimately just and correct and efficient. Well, I would say what is wrong with diverging from a system that is inefficient and unjust? I would say that, again, 200 years ago, there was a group of well-meaning people, a lot of whom initially spurred some of the action that led to the American revolution. But, these people felt that the real problem was that the king didn't know his own interest. That the king was listening to too many of his

privy councilors, who had their own interests, but that ultimately the king's interests were absolutely the same as the colonists interests. Therefore, the torries said that if you could only more efficiently petition the king and force him to see his own best interests in spite of himself, everything would be fine.

But, I would suggest to you that until Roy starts defining some of the specific things that he has alluded to in his paper, that he would like to see changed -- and until he defines the overall question, what is the economic impact of this process -- that arguments that all we have to do is make this system a little more efficient are wrong.

Purposes of Pension Asset Investments

PURPOSES OF PENSION ASSET INVESTMENTS

MR. LINGUA:

I think the question was -- and I'll try to answer that first -- what's the purpose of pension fund investing. I'd submit a simple one-line definition: to be managed productively as well as prudently in relation to the risks that are assumed. Productively is the key, the operative word. How well that job has been done, will be judged retrospectively by the next generation of workers and people in our society. The difficulty in finding, Karen, the equal yield investment is knowing that it will be an equal yield investment in the future, not just that it has been in the past. Many investments can appear to offer equal opportunity for return, but we won't know until years go by whether that is true or not. The problem with saying who bears the risk is, I think, that everyone, all the major parties bear the risk. And if pension policies are followed that turn out to be poor in terms of productivity that will be judged by the next generation of workers and people that finance the plans as having been inept policies however well meaning. So you cannot have any comfort perspectively when you are in effect trying to play God. This pool of capital will have to be replenished over and over again. It doesn't do a lot just to keep rearranging the pool that's been accumulated be it $500 billion or when it's a trillion. It's assuring that that pool, that flow of capital -- new blood to revitalize our economic system to build new plants and to finance new technology -- will be continued. And as someone who has managed these pension funds with the interest of the beneficiaries always upper most in my mind, I assure you it's not as easy as has been described today to make these judgments between what is equal yield and where you can get something else for nothing attached to it.

MR. SCHOTLAND:

That last point that George made about the difficulty of knowing what you're doing in terms of lost investment return when you go into divergent investing is splendidly brought out by the Heritage experience in trying to handle the University of Wisconsin endowment. Mr. Windsor says he thinks it will be four or five years before they know what the move out of 40 to 60 percent of the S & P is doing to that account. I don't

hindsight you can't find a lot of difference in the performance of the remaining universe as you can in the universe you had to work with to start with.

The one major area that is different is that you're dealing with smaller companies on balance. Whether that is going to be good or bad remains to be seen. So far in 1979, that's been good because '79 has been a good year for small companies in the stock market. There are people who say well, it ought to be a good philosophy on a long range basis. Well, don't you make more money investing in small companies which have most of their growth ahead of them rather than in large companies that are relatively mature? We don't know. We do know you take large risks in investing in small companies. And I don't think there's any way that we can tell at this point whether this philosophy is going to produce as good a rate of return, or even an adequate rate of return, in the future.

One of the problems that comes up when you try to work around a large exclusion is the fact that trustees and plan sponsors are both logical and human at the same time. And the conflicting goals of a special set of investment criteria conflicting with other things that the sponsors would like to achieve can be very tricky.

Specifically, let's take this endowment problem -- and I don't think it would be peculiar to an endowment and could well apply in the Taft-Hartley area as well -- where we're trying to produce a specific level of current income as well as a long term total return. The fact that we cannot invest in some major classes of securities is a real problem. And trying to tailor, not only the South Africa strategy but the other strategies together into a coherent whole is a very difficult problem.

I think we've all talked here today about investing as sort of being an automatic faceless process. That is not the situation in most accounts, and any of you who have run money for pension fund sponsors know that. This is a set of criteria that is very difficult to build into the normal kinds of decision making processes.

I'll also say that in terms of management techniques we have had to, in effect, create a new universe of securities to work with. We have not been able to work off of the normal lists that we use. We have not been able to use our normal investment strategies in managing this endowment fund. That is a costly process and creates some major management problems in an investment management firm. I simply warn those of you in my business that it is not easy when you start to exclude major portions of the investment universe. And it is far more expensive.

In terms of active management, it is very difficult because an active manager is trying to achieve a certain investment thrust

of concentrations and emphasis, yet this strategy really robs us of many of things that we would like to invest in. For instance, at the moment we're very restricted to what we can do in the capital goods areas and in the high technology areas simply because we don't have the investment vehicles that we need with this exclusion. So I think that this approach is going to be very different and challenging for active managers. As I've been listening this morning, I wonder whether a passive approach, if this type of investing is adopted, might not be a better approach, that is, using the techniques of MPT to try to create some sort of an index fund with a social tilt to it as a current vernacular. Where investment thrust is eliminated, all you're really trying to do is diversify as broadly as you can in the stocks that you can invest in.

The last point I'd like to make is one that Roy brought up and that is how do you judge how well you're doing. In the real world of investment management, we're judged -- unfortunately with too much frequency -- but quarterly at a minimum and sometimes more frequently and certainly annually. There really are no criteria with which to measure investment results that are not skewed in some direction or another by non-traditional criteria. We have created, for the University of Wisconsin, the S & P 383 which is what's left. A strange and wonderful beat, believe me, to try to give them something to check, use as a benchmark to measure how well they're doing. We find that in 1979 we created a very difficult challenge which we never thought of. It has, because it is small company oriented, done 500 basis points better than the standard Poors 500 so far in 1979. That will not necessarily be the case in coming years. And we've figured out its characteristics and the past growth rates of the securities in it both on a weighted and unweighted basis, and we've done all those statistical games and yet, we still do not know -- and I'll finish this off by going back to George Lingua's comments -- none of this will tell us what will be accomplished in the future.

We know what it would have done in the past, but we're dealing in a great area of uncertainty. That being the case, the problem of the investment manager and the fiduciary will only be judged in hindsight simply because there is no way to make these decisions ahead of time which will be a very complex environment in which to try to sort out whose liable for a claim.

MR. SCHOTLAND:

Let me just underline what I think he was assuming without bringing out. The Wisconsin fund is peanuts compared to a state and local or a large corporate. And I'd expect, Mr. Windsor, you'd agree that with a large portfolio the problems would be yet worse?

MR. WINDSOR:

Yes, this portfolio is only about a $12 million portfolio. If we were talking about a couple of hundred million dollars, I don't know where we would find enough capitalization to fully invest.

MR. SCHOTLAND:

The only other point I wanted to bring out was when I was talking about the problem of keeping up with inflation and the problems of improving benefits, and according to my information, the median income of widows 65 and up as of two years ago was 66 dollars a week which means half of them are below 66 dollars a week, which I find pretty horrifying. So we need some benefit improvement let alone trying to stand still. This can come with better performance. And the area where I think the investment performance is most important, because the bargaining process isn't just across the table, but with all citizenry, is in the state and locals. And there I think if there's been weak investment performance, those are the funds most vulnerable to these arguments. Benefit security and divergent investing are not compatible goals.

MR. BEERS:

I'd like to comment on the remarks made by Mr. Windsor and some of the aspects of Mr. Schotland's paper along the lines of whether or not we're talking about social investments from an inclusive or exclusive mode.

It seems to me that the ERISA requirement is clearly one of diversification and, therefore, if a specific policy calls for a significant exclusion of certain types of investing that in of itself raises a fiduciary problem. In fact, I think that Mr. Schotland's paper makes two points which seem to me to be especially important. First, that there is a growing concentration of pension money in corporate securities, both equity and debt, and second, the fact that those funds have underperformed the markets. These factors raise a series of questions regarding the invesment of those monies. It seems to me that the thrust of investing ought to be towards increased diversification into perhaps more mortgages real estate, not to the exclusion, of course, of corporate securities, either equity or debt, but in order to obtain as wide a participation in all forms of capital and other forms of investments that's possible in our economy.

MS. MARES:

Something that John Windsor said made me think to raise the question of whether or not from a legal standpoint there's a difference between a sponsor making the decision to select an

investment manager who focuses primarily on small capitalization companies and the decision to exclude companies who do business in South Africa and end up by default with a universe of companies that are small capitalization companies. I think that there would be a different analysis of the prudence of those decisions.

MR. HUTCHINSON:

Again, I find it helpful to break the analysis in two pieces. One, as a matter of prudence, if you know that the result of your exclusion policy is going to produce a range of options that's by in large concentrated in the smaller capitalization companies, that's a pretty knowing decision. You can go in knowing that's going to happen and that's how your prudence will be measured whatever the reason for your investment decision. But the second test is the one of whether you're investing in the interest of the plan's participants and beneficiaries. And I hate to keep beating a dead horse, but you've got to jump over both of those hurdles to make it. And if you could demonstrate that the investment activity was undertaken for the purpose of serving some other need, as opposed to essentially a conviction that that was the investment strategy in the best interest of the fund, you expose yourself to that additional risk that it will be challenged upon that basis, not because it wasn't prudent. And one of the things that came up this morning -- if I can extend just for a minute here because I think it might help clarify a conversation Mr. Glover and I were having -- there is a difference between potential exposure and liability that results from imprudent investment judgment, and the kind of exposure or liability that may nonetheless result merely because you didn't take the plan participant's and beneficiaries' interest into account to the extent you should have. You could arrive at a decision to select exactly the same company if you went at it under the prudence rule solely from an analysis of the investment as is consistent with your needs as someone who had no interest in whether it was a union or non-union company would arrive at the same result. The problem is created if you do it for purposes other than the best interest of the plan participants and beneficiaries. It essentially gives a challenger another hook to argue with you on. And your question, how can you be liable if it was a prudent investment, and if you invested it for totally neutral reasons it would have lost money as well. And you can show that. The assessment of liability under ERISA for better or for worse doesn't say that you're assessed liability only if you were imprudent. It says that for sure. It also says, though, you can be assessed liability for losses that occur through your failure to follow the other standards in the law as well, such as a prohibited transaction, not acting solely in the interest of participants. And I don't mean that to sound technical, but there are a couple of different ways that liability can be assessed. One is if you were to act prudently

and another would be, for example, if you were engaged in a prohibited transaction which results in loss. And you can be held accountable for either one of those reasons.

MR. BARBER:

Jim, I wanted to ask you a hypothetical question. One of the major problems in this whole area -- and we are clearly posing some theoretical constructs trying to back them up with facts where that information has been gathered and one of the major frustrations that all of us have is that there's been a lot of labor in this area but very little real study, which I also tried to point out before. But just for the moment, let's assume that a series of unions or foundations have commissioned a study which pretty strongly demonstrated the relationship between the ability of unions to win increases in the total wage package and specifically in pension funds, and the relative strength of unions at any point in time. In other words, the stronger unions were the more election campaigns that they were winning, the greater portion of the labor force that they had organized, the better they were able to enforce various kinds of increased in terms of wage package and in terms of the pension funds. Or, demonstrating that there is a connection between the strength of the labor movement and the ability of the individual participants, especially in an inflationary era, to collect a pension benefit. I assume that then trustees of various jointly administered funds or negotiators for unions which are dealing with unilateral funds, like the steel workers or something like that, essentially put that language into the plan document in terms of saying we understand that there's a direct connection between the strength of this entire area of the economy and the ability of our individual participants to be able to collect not only the pension fund that they have now, but especially in terms of inflation to be able to keep up with that.

Would you consider that to be an adequate justification for then pursuing a policy that focuses far more heavily than they do now on investments in areas of the economy that are relatively well organized.

MR. HUTCHINSON:

I'm intrigued by the possibility that that kind of research could occur. And I'm not being facitious at all. I think that there's a great deal of work to be done in this area if that's where it is. I guess the analytical problem I have from the statement of the law today is that by and large a fiduciary judgment as to whether to accept instructions like that, whether in a trust document or not, have to be some way related to the best interest of the participants and beneficiaries in that fund whose money is being invested. And, even with the showing that large companies that are organized and have sound

labor management relations produce a higher level of benefits for its workers across the board, and even retirement benefits more specifically, shows a good rationale why that would be an attractive investment if you were interested in fostering collective bargaining and representation. But you'd have to make another leap, I think, to make some sort of analytical showing that investing in those companies is in the best interest of the plan and participants and beneficiaries as opposed to kind of the world at large, just analytically.

I'm talking about breaking it down. You've assumed or predicated what I think is a major first step and that is do we have data like that to even begin the experiment with. But if you did, I'm trying to look at what the questions might be that arise. And the one that I see is in the light of that data, the highly organized sector of the economy by and large produces greater wage benefit packages and including improvements and benefits for the workers. Is that closely enough tied to the interest of people in this fund to produce the kind of thing that a fiduciary ought to pay attention to? The point I tried to make this morning, and one that I want to reinforce now, is that notwithstanding personal predilictions, I've been trying to keep my role restricted to an articulation of where we are in the state of the art today in terms of legal standards alone -- they can talk about investments over there and I'll listen a lot -- as opposed to where the law ought to be or whether some modifications that could be made would indeed be in the best interest of how these funds ought to be managed. And on the second issue, as I say, there are a lot of personal feelings that I have. I try to keep my role articulating where the law is today. And I think that a lot of the questions that are coming up now about what would the law be if, I don't have the answer to and probably most people don't have the answer to. I'm just trying to identify the question areas and we might really spend our productive time trying to figure out where it ought to be in terms of influencing the President's Commission or legislature or anyone else who ought to be influenced in this area.

MR. BARBER:

I'm interested in hearing your opinions.

MR. HUTCHINSON:

We talked at lunch today about the representation of retirees in the investment process or the objective setting process. I find it difficult to make an argument of any kind against that notion. I don't see that it's a matter of public policy. There are obviously some difficult mechanical problems on how you implement it, but as a notion of policy that's an argument that I find hard to deal with in terms of opposition.

And I don't -- it depends on the issue.

MR. GLOVER:

I want to respond to what Jim said about beneficiaries being included in pension committees. Obviously they have rights and they should have something to say. But the important thing you've got to remember is that all the time they were getting these benefits and were part of the pension program and having funds put in for them, they were perfectly willing to live with the plan the way it was. I'm not trying to speak on either side of this. So when they become beneficiaries and see that the economy is eroding away some of their benefits, they say, we shouldn't spend so much for increased benefits because I don't get the direct benefit of it because I'm on pension. So, we should put in a cost of living increase for pensioners. Now there is a different position that you have to take there because he's already vested and he's going to continue to get benefits. The guy that's on the job, if anything happens to the pension plan, he doesn't get anything even if he's vested. When it comes to him getting his part, he's going to get less of it. So he's got more to risk than the guy who's already retired. So my concern is how much weight they had, not that they shouldn't be represented. But there are certainly cases in a declining industry where the beneficiaries or the retirees can far out number the actives. And they, you know, can do anything they want with it. I think these factors have to be sensibly weighted and you have to address yourself to those problems. In almost all instances of which I'm aware, the primary person you'd better be thinking about is the one who's building a pension, not the one who already has one. He had his shot at it when he was there, and he should be considered but not be given that kind of weight.

The Issue of Investment Return

THE ISSUE OF INVESTMENT RETURN

MR. FRIEDES: We could now try and go to assuming equal return. And I realize that especially in the investment world, that sentence, assuming equal returns is more than nebulous. It's perhaps impossible to try and ever determine ahead of time. But we're talking theory. A lot of it is theoretical so let's continue on that.

What are your thoughts on what kinds of things can or should be done without trying to sacrifice a return? What can be done, what should be done, what kinds of things should we think about, what kinds of problems, what kinds of things are people suggesting we think about and who would like to discuss something that relates to assuming equal return?

MR. LEIBIG: I feel a little uncomfortable starting with the assumption when everybody assumes the assumption is not true. But I still think that in a way that very framework relates to a lot of things that are being said because there tends to be a lack of reality unless you're in a very specific area. I think that the key question is a question that if it could be settled, would be very beneficial both to the advocates of more social investment, which I think I side with, and those who are concerned about what that might mean. It is the question of whether there are circumstances in which a trustee who refuses to make a social investment proposed to him could be liable for that decision. Are there situations where a trustee says, I'm only going to consider the economic impact--and I've got a definitional problem--but I'm only going to consider the economic impact of this investment and I don't want to hear about all this social investment stuff? Is he always safe in doing that? I think that not only do we all agree to a lot of other things that he said, but I think we all can agree--at least I think probably all the attorneys can agree--that he's probably not safe in doing that. If such a trustee is presented with, for instance, a poll from the participants, a total poll from all the participants, that they are all interested in having a policy set that no investments will be made in --

MR. FRIEDES: South Africa.

MR. LEIBIG: -- South Africa, for instance. If he's got that poll, if he's got firm financial evidence that an investment he's considering is an investment in South Africa and that's

presented to him, and yet he still decides to invest in South Africa, I think we can all agree that he might be subject to legal action for an injunction or otherwise to prevent him from doing that.

MR. HUTCHINSON: No, not at all.

MR. LEIBIG: He wouldn't? Then that is a fundamental issue.

MR. FRIEDES: Vance would like to respond to that.

MR. ANDERSON: Let me suggest that your hypothetical needs to be a bit more complicated before you can break it down to a decision. But George, you throw your hand up or hit me with a glass of water if I get to far out of line with this. I think were an investment manager to be presented with a direction from an appropriate party under the terms of the plan, one that was authorized to issue instructions to a trustee--who I might add would probably be a fiduciary in making such instructions--and were those instructions to be proper on their face and authorized by the plan and not on their face imprudent, then I think that your hypothetical might well bring you to the position where you would have a fiduciary question of the obligation of the trustee under the terms of the plan and of ERISA to exceed to that proper direction. But I think the key element in your hypothetical, and in much of the discussion that goes on, is the question of propriety of instructions: who it comes through and are they in fact autorized to issue such instruction. Or, let's rephrase it, make such investment decisions.

But it's clear to me at least under ERISA that others may be authorized by a plan to serve as fudiciaries for the purpose of making investment decisions, and that in fact trustees are obliged in certain cases to exceed to those instructions.

MR. LEIBIG: My point was if the person handling the fund presented with evidence that an investment that he is considering making is socially detrimental, and yet the option is socially beneficial, and yet he makes the socially detrimental one on the theory that since I'm only going to look at the financial implications I don't have to worry about that, I think that a case could be brought and made where he would be subject to some liability or at least to some kind of injunction against making that kind of investment.

MR. ANDERSON: You raise an interesting point because you're suggesting that at that stage that investment managers generally, whether they're insurance companies, bank trustees or independent investment managers, can in fact have the purview of their engagement broadened out beyond one of simply making investment decisions which go to performance and safety of the funds.

They can in fact be put in a posture where they become social arbitrators or social philosophers or moral philosophers

or political philosophers. I would question whether or not that can be implied from the statute.

MR. LEIBIG: Well, I'm saying can they be put in a position where in assessing the interest of the beneficiaries they are allowed to completely limit that assessment to financial analysis?

MR. ANDERSON: I'd like to point out to you that with exceptions that may exist but which aren't totally unfamiliar, that when a plan engages the services of a financial manager I think that their understanding is that they're going to receive financial advice. And were I to be a plan manager, were I to start to receive a great deal of social philosophizing from a financial advisor, I think I might have a question or two.

MR. LEIBIG: And some plans might look for financial managers who are willing to do that. I know, for instance Becker is trying to develop ways.

MR. ANDERSON: Sure. And to the extent that plans choose to engage individuals to do that we've got a slightly different scenario I suspect than what we're dealing with now.

MR. FRIEDES: Mr. Smart.

MR. SMART: I would suggest that the importance of whether or not social beneficial criteria enter in is getting greater credence. One of the problems in trying to get any kind of consensus is the fact that whether you're talking about a defined benefit or defined contribution or a target or an IRA or whatever it happens to be, there are some differences there. And so when you're talking about whether it's a public plan or a private plan you're talking about some differences there. And I would suggest that the kinds of alternative investments or diversion or whatever you want to call them are going to be appropriate depends on the kind of plan and depends upon the group of beneficiaries.

I'll give you an example. The Wisconsin retirement system is a hybrid. It's a defined contribution and a defined benefit plan. Vesting is immediate. Employees make contributions so that it's employee and employer dollars going in. There is a strange history that gives it almost everything that we've been talking about, and that makes it both simple and complex at the same time. So, what kinds of investments are appropriate if you're going to concede that we can make certain kinds of "socially sensitive" investments? I think that there are investments that we all know exists. There are many small businesses that do not get the capital that they need and deserve. And the Investment Board has a restriction in Wisconsin that they do not make private placement loans of less than $3 million to any one entity. They have not explored the possibility of combining small entities that might only need $300,000.00 into a $3 million package. And unfortunately, an intermediary doesn't exist. I would suggest that one should be established.

MR. FRIEDES: Karen, I think you were next.

MS. FERGUSON: I would like to comment on Mr. Leibig's example. As I stated at the outset, my interest in coming here was to get a consensus. I fear that if we stand with Mike's hypothetical we will not get one. Mike posited what I find the hardest case, a case in which there is not a legal obligation. I would like to give a different hypothetical for a private plan, as contained in my paper.

The trustees are fully aware of the investment. It was brought to their attention in fully documented form that in every way, shape and form investment in a particular company would have the effect, assuming it's a competitor, of undercutting the wages and then ultimately the pensions of the participants whose money is being invested. If we discuss this example, I think you may get to step one.

I would also say in passing, that Anderson's idea of the corporate sponsor giving instructions to the fudiciary is, I think, a very unfortunate situation. It does make the corporate sponsor a fudiciary. I think it is a vestage of pre-ERISA days and we're stuck with it for now. I don't think it's going to be with us forever because it's basically inconsistent with what ERISA is about.

MR. ANDERSON: If I might clarify what I was proposing, Karen. In no way was I suggesting that it be the plan sponsor or not the plan sponsor. It could be. All I was suggesting is that one of the difficulties of contemplating those kinds of directions is that the professional investment advisor will need to know he's dealing with the proper party who's authorized to deal and that he is receiving instructions which are in fact appropriate. Whether that be the union or the sponsor or an independent committee. It's a very serious problem for the trustee and the professional investment manager to know who to deal with.

MS. FERGUSON: Let's say you have an ad hoc group of participants who are IAM members and come up with absolute indisputable evidence that the impact of this investment will be to harm their own pensions. In that situation I think the trustees, on their own initiative, can determine the validity. In my paper I suggested that to defend themselves, if they didn't want to make the investment, because the prudence rule goes to procedures and careful examination of alternatives, they would be well advised to file what I would call an investment impact statement: a statement of the reasons they didn't make that investment. That would probably be a very good defense.

MR. FRIEDES: Mr. Lingua.

MR. LINGUA: I'd like to give an investment manager's answer to the question. When you do find what appeared to be equal

yield investments, what should you do? To make this believable I'd like to say equal on a so called risk adjusted basis, they're not just the same yields exactly. One investment is a new U. S. Treasury issue of 15 year bonds, $5 billion, at, say, 11 percent.

The other is, say, a U. S. Steel Corporation issue of 15 year bonds, $5 billion, at 12 or 12.5 percent. And, professional investment managers do agree that they seem to be fairly priced in relation to each other on a risk adjusted basis. Which way shall we go?

I'll reveal my own personal prejudices to social and economic desireability. I would go for the U. S. Steel issue rather than lend more money to the Federal Government to subsidize or to finance the present deficit or make a larger deficit possible. The U. S. Steel issue has many things to recommend it. It's going to be to build a modern new plant in the northeast that will employ new technology and probably enable us to compete more effectively with German and Japanese steel. It has new technology which will also reduce environmental pollution. It's just a wonderful investment to be able to make. I would make that investment, but I can't do it because the pension funds that I'm investment manager of have knocked it for reasons.

U. S. Steel is doing some business in South Africa. Presently their plants are not up to EPA emission standards. And they've just been accused, not convicted yet, by the EPA of being a persistent violator. They're accused so we have to cross them off for that reason. There are other reasons on the checklist of why I cannot invest in that wonderful opportunity.

Now let's say they get the money anyhow even though the funds I manage can't participate. They have to pay 13 percent, but they get it. And there are two possibilities there, the technology works, emissions are reduced, the environment is better, we compete better with Japanese and German steel, more people are employed, jobs are secured, U. S. Steel's future is better assured. That's the happy hour.

It could be that the technology doesn't work -- it'll work ten years later but this wasn't ready. If it doesn't work, then they haven't been equal yield investments. And the ones that then say ah, I see we were wise in saying you shouldn't invest in U. S. Steel, we should have bought the Treasury issue. Interest rates went down and that issue went to 110.

MR. SMEDLEY: A very quick observation. I'm rather shocked at the statement you were talking about, which is the better investment and we shouldn't let the social criteria enter in it. We do it on the basis of what was invested.

MR. LINGUA: You couldn't do it.

MR. SMEDLEY: All right. But the point of what you said is I don't want to invest in a government issue to help finance that Federal deficit. You made a political opinion. You're entitled to that prejudice but somebody else is not entitled to prejudice in regard to South Africa.

How many investment managers are doing this? The other side has as much right to make that decision on a political -- prejudicial basis as you do.

MR. LINGUA: Exactly, and bear the consequences. I repeat, and be responsible for the consequences.

MR. WINDSOR: I'd just like to add a little more to the investment manager's dilemna that Vance talked about. Our experience in several instances is that the sponsor wants us to try to make these social judgments, which is not our business. He wants them made but he does not want to accept the responsibility for that direction -- the consequences. If it doesn't work, he wants us to be the ones that assume the responsibility for results that are not adequate. Until we decide on whose going to hold that hot potato, I don't think you're going to find much sympathy in the investment management industry for trying to do that kind of a job. After all, we're not the ones that are setting this non-financial criteria to follow.

MR. SCHOTLAND: Don Smart's comment about some good investments not yet available reminds me of something that came up yesterday in the American Law Institute -- American Bar Association talk I made about conflicts of interest and non profits. Somebody asked if it's okay to spend the total return concept, can we spend to realize the appreciation. And, of course, the Board Foundation study by Bill Cary says, yes, of course you can. And the Uniform Act says yes, of course you can. And counsel for the university argued you can't though the New York State statute says you can. He also argues that you can't spend unrealized appreciation. Well, I'm all for spending unrealized appreciation and I'm all for investing in wonderful investments that aren't yet available but what if the yield doesn't occur? So I'm not interested in talking about investments that aren't available. And ap propo small business, I wonder how many of you noticed the Lou Harris Poll for Chemical Bank in which small businessmen put more access to capital about fifth in their order of priorities. I think we've got some perceptions that don't really exist. I'm sorry that Peter withdrew the phrasing from equal yield investments. I think we have some concrete examples. I think there are times when mortgages are at least equally attractive to alternatives. I doubt there are any times, at least I'm not aware of any, when they yield less than Treasury's. They have full Federal guarantee. We now have a hugh amount of them in total equity. I'm not even sure that they're not better than Triple A funds in terms of riskyness. Certainly over the past two years or so they've out yielded Triple A bonds. I think according to the most recent mortgage -- the November mortgage guarantee survey by about 70 basis points.

Now why on earth aren't there more holdings in then?

If you go back to 1975, there were 66 billion outstanding in total Federal housing related instruments; Ginny Mays, Freddie Macks, Farmers Home, and Fannie Mays. If you come down to the end of '78, that had gone up to 131 billion. It's now 141 billion. Back in '75 it was about seven percent of the outstanding corporate bonds. Then in '78 it's about 12 percent of the outstanding corporate bonds. And yet, I submit that they're under invested in the private area, particularly in private pension funds.

It's also seems strange to me that the states and locals do the mortgage investing they do. Oregon buys a huge batch of mortgages. Then when the money really gets tight they're portfolio is full of mortgages at just the time they could get the optimal yields, do an economic and socially constructive act. So it seems to me that properly timed moves into indirect mortgage instruments can be very profitable. Pension funds are the ideal mover at just the times that this intermediation occurs. The yields are going to be good and your long term holders say why isn't there more holding here.

MR. LINGUA: Roy, you must be aware that that's been the most rapidly expanding area --

MR. SCHOTLAND: Yes.

MR. LINGUA: -- in the whole damn market. We quite agree with you. They are very attractive and pension fund managers have recognized that and invested enormously. You could not find a better example to cite of being responsive to a very high quality investment, that becomes available in large volume, that has many other very useful aspects to it. Pension fund managers have used it to a great extent. I think you make our point though.

MR. SCHOTLAND: If we look at end '78 Trust Department data, there are under six and a half billion in aggregate holdings, in real estate mortgage pool pass through certificates. That's almost all surely Ginny Mays and Freddie Macks.

MR. GLOVER: Yes. I'm interested to see that there are some different criteria being used now because in the past investment advisors used to compare themselves to the indexes such as the Standard and Poors and the Dow. Nobody -- or at least no one has brought the question out yet, what about anticipated yield on the pension trust assets? Isn't that also a criteria. So if you're meeting the expected yield and you're meeting all these other indexes, that's no longer enough. Now all of a sudden, if you determine for some other reason that you wanted to make an investment then you're liable in some way. I cannot get it out of my mind that somehow or other somebody is

taking it out on collectively bargained agreements, quite frankly, where most of this exists. And I don't see why in the hell they'd lay that on top of this structure you've already set in place and everybody's accepted for years as being the standards which you work against. Now all of a sudden because we think it's socially acceptable, and some other community or some other sector of society thinks it's not, then we now have to be laid on the alter and crucified again.

Hell, if I could just do as good as all the rest of you are doing why would I be, as a fudiciary or any fudiciary, strapped up on a cross like this. I don't understand it and I want to know how you justify that.

MR. FRIEDES: Anyone want to respond to that? Roy.

MR. SCHOTLAND: Well, I'm speaking without the expertise--and others will correct me among the actuaries--but I think first of all your actuarial return estimate is a conservative assumption about the future. And if you're going to start pegging your investment policy on that, it's going to start being altered.

Second, if you start making some investments which are not aimed at maximizing yield but just beating the actuarial figure, it is going to be yet further revised. It assumes an effort on the basis of long run experience in the financial markets. So I think you've got to stay with the indexes we've got and not start using the actuarial assumptions which are not intended targets.

As for questions, I'd like to know why the machinists, for example, with what is it, somewhere between 60 and 70 million, put only three million into a Drexel-Burnham effort at this stuff when as far as I can determine, Drexel-Burnham doesn't even have any criteria at all. It's purely Drexel-Burnham merchandising. And why Mr. Wimpsinger said it's a terrible thing to be in Kodak except the fund is in Kodak. And questions like that.

MR. GLOVER: Well, I'll tell you. In many instances it is because we've got employers on the other side of the table that we have to get an agreement from. And, they seem to have some of the community of interest that you put into your thinking here, with which obviously I don't agree in many instances. But it is a fact that we all have a responsibility. And what we try to do is convince the employer that this is a good investment. And it takes a period of time to do that. It doesn't come overnight because some employers are somewhat more conservative than we are. I know that comes as a surprise, but it's true. And it is hard to implement this. And the reason why we did it in Drexel-Burnham--and that doesn't come out of an employer, that's one that comes out of our own fund--is because we wanted to do a pilot program. That's something that we're concerned about.

We're not absolutely certain, and notwithstanding all of the certainty there is in the investment community, that we're right. We might have to bounce that off against the investment community which is absolutely certain that we're wrong. So, you see, we do have some room to move. We realize that we're able to learn in this area. But hell, we're going ahead with it. We're doing it as quietly as we can because so many people raised so much hell. You know, what they don't know don't hurt them. So we do the things behind the scenes that we have to do to get it where it's got to go. And we're not going out and telling everybody what the hell we're doing either because we think that we're legal. And we're going to wait until they catch us.

(Laughter)

MR. GLOVER: Now there's nothing wrong with doing that either I see none of this conflicting with the indices that they've been using in the past, but all of a sudden there's nothing wrong with it. Hell, that's the Becker report. We get rid of investment advisors on the basis that they don't live up to the Becker report which everybody thinks is great. Now somebody says not only that, if you make a decision that we say--whoever the hell we is--is socially unacceptable and you think it's a social commitment on some part by your organization, we're going to hang you up on a cross for that. Where does it come into the picture, all of a sudden, that we cannot do what we propose as long as we meet the indices that have been established and accepted in the past.

And most of the people I've heard from, what I consider to be the management and financial community side, are saying we're wrong, they don't want to argue that. I had a recommendation come from one of our investment advisors the other day and I thought they were equal and they thought they were equal. One of them was socially acceptable as far as I was concerned and the other one wasn't. Mr. Ennis says there's no such thing.

MR. SCHOTLAND: No, he even didn't. He said some economists argue that. You can find some economists to argue anything.

MR. GLOVER: Well, they're all two handed, right.

MR. FRIEDES: Mr. Harrington.

MR. HARRINGTON: Yes. I represent the Service Employees International Union in Sacramento and also sit on the Investment Board in Sacramento which has about a $100 million portfolio. And a lot I've heard today is really interesting. I think a lot of people are too wound up in academia. I also think a lot of people are in fairy land when they talk about social investing. I think social investing is a real misnomer and perhaps a real bogus argument. Maybe what people ought to start talking about is total economic yield. In Sacramento anyway, we've been looking at a number of our investments. And by the way, I should mention, too, that our system is somewhat unique in that we have

no employee or retiree representatives on the Board. And we have what's called a self-liquidating system. In other words, beginning in 1977 all new employees went into the state system, both safety and miscellaneous members. And so our system eventually will self-destruct.

What I'd like to talk about is total economic yield and the fact that for some reason most people try to avoid the reality of the fact that every time a dollar is invested in the economy it has social, political and economic impact. And nobody's talked about that. When you invest a dollar in Iran or you invest a dollar in gold, or you invest a dollar in the Sacramento SBA program--which by the way, our pension board is doing in an increasing amount--you have an impact. You have an impact on both the positive and negative sides because if that dollar didn't go to Sacramento it would have gone some place else. If it didn't go to Iran, it would have gone some place else. It may create jobs. It may maintain jobs. It has an impact on the tax base. And those kinds of impacts are final and hopefully will be looked at and scrutinized. They have an impact on your portfolio. If a company is in Iran and it gets appropriated, nationalized; that has an impact on your company. It has an impact on your beneficiaries. And I think that those kinds of decisions are made by corporate management and I think it's somewhat naive to think that when an investment decision is made money managers, fudiciaries and corporate management doesn't look at the total environment in which they invest those dollars.

Now it may be, as someone had pointed out earlier, and on occasion I've pointed out, that we can make more immediate dollars off slave labor. Perhaps that's so. And I think we ought to be very clear and say we can make more money for our retirees in South Africa off slave labor. That maximizes our total financial and economic return. And I think we ought to be honest and do it.

But most people avoid that subject and avoid total economic yield. I would hope that this discussion today will lead to a broader discussion of total economic yield in its full impact since that's what we're really talking about. Social investing is a bogus argument. Every investment is a social, political and economic investment. If you don't think so, I think you're fooling yourself.

POINTS OF CONSENSUS

MR. FRIEDES: How many people here would advocate an acceptance of less return to achieve a social objective; consciously less return? Mr. Smedley, Mr. Glover, Mr. Tower, Mr. Gray and Mr. Smart. I'm just trying to get some idea of who consciously would accept less return.

MR. TOWER: Before I speak to why, I just want to make sure that you understand what I'm agreeing with. On the question of whether you consciously accept lower return, I think you've got to look at whether the law actually requires a maximization of earnings on every possible investment. To what extent can plan sponsors, can investment managers, can people who are making some sort of decision as to so called social investment, look at funding objectives and return objectives and say we have been performing better than those. Therefore, we can look at our entire portfolio and play around with diversification a little. We're operating with a certain amount of private placements that are giving us absolutely phenomenal returns; we're operating with a certain amount of bond fixed issues that are giving us very good returns; much more than are actuaries are telling us that we need. Can we then go and come up with what would traditionally be considered an absolute bum of an investment. But it's an investment that is socially beneficial in terms of a definite affirmative social program, such as aiding a business that participants will have some root in because it will affect their livelihood or their living standards as retirees. Can we look at it's yield risk figures and invest some fund money, hope that the risks pan out and we do get the yield.

Can that type of investment be made? Or does the law require every investment action to be one that seeks absolute maximization of return? I haven't seen anything in the law or in the legislative history of ERISA, or in court decisions under the common law that indicates that maximization is necessary when you're talking about a pension trust as opposed to a personal trust, where maximization is the goal. And I think there is a distinction between a defined benefit plan in this instance and in defined contribution plan. In a defined contribution plan I would read that maximization is obviously the goal. But in the defined benefit plan we've got this -- you've got your actuaries saying hey, you're giving so much money into the fund, you only need a return of five percent, you're getting return of 10 percent. What do you do there? Can you make that social investment?

MR. FRIEDES: There are very few pension funds that are getting that level of gains from their investment.

MR. TOWER: The question isn't simply one of what the present world is. I mean, we're in an obviously rotten economic situation and you've also got to deal with inflation today. But say, wishful thinking perhaps, if we got back to a universe where we're dealing with three and a half percent annual inflation and mechanisms can be worked out to accommodate tnat, in the instance where you have a good pension fund where it is being well funded and the investments are being operated in a way that does give this good return, at what point does prudence allow you to make the type of investment that I posited, one that gives you a lower yield than you would normally seek?

MR. FRIEDES: Any investment managers willing to try that one?

MR. LINGUA: I really sympathize and would like to be able to say that I believe that what you describe is going to happen. I just don't think it will. What you're describing is a pension fund that has achieved such a surplus that it, witn the knowledge and consent of its participants, is saying, yes, we will forego some additional benefits that we may get in the future.

No one is ever, I don't think, going to be satisfied tnat they have all the benefits that they want. They don't have to worry about inflation any more and they don't want more benefits. The world is always going to be too uncertain for that. And no actuary is going to tell you whether the rate today, even if it's eight percent, takes care of everything. If you want eight percent, we absolutely write you a guarantee for 30 or 40 years that that will be enough to keep your pensioners ahead of inflation. In real terms, no one can give that assurance. So what you're describing, the pension fund that has such a surplus and such a certainty for the future that it can consciously tell its investment manager that he no longer has to make every investment decision on the basis of maximization of return, but rather in terms optimization of the risk that you want to assume. And that risk is also the uncertainty of what return you're going to get for the future.

MR. TOWER: I think I'm putting a few assumptions into the model that you're not.

MR. LINGUA: I'm sorry I missed them.

MR. TOWER: In any of these instances you've got a conscious decision, most likely by the retirees, That's what I posited, that you have a conscious decision by the retirees that what we're looking for is not continually increasing benefits. We have made the decision that retirees are participants. We've made the decision that we want the fund to be operated in a manner that gives us senior citizen housing in the location in which most of us are retiring. That's a bad example because that's one that you can obviously come up with in equal yield, or more easily come up with in an equal yield and risk situation. But such a project is what I'm aiming for. And further, looking at

the time frame in which you make investments and in which the prudence rule requires you to operate, it's not a question of assuming that benefits will be increased under a plan. You're to make assumptions about what that investment will do given the present operating conditions and the present state of the pension plan. You're not making the assumption that benefits will be increased to match inflation every year if there is no COLA adjustment in that plan. You're not making an assumption that benefits will be increased five percent every year, every five years, if experience indicates that it's only been increased one and a half percent every six years. There are certain operating assumptions that you've got to live with. And given those, can you make these investment?

MR. LINGUA: More than anything in the world, I would like to be a participant in that kind of plan that you described. Not just as a retiree, but someone who's expecting to come up to retirement within ten or 15 years. That's soon enough to be concerned about it. And I would love to be able to say that yes, I want our fund to be invested for some other reasons.

MR. TOWER: If I could find such a plan, under such economic conditions, and with the noted participant directives, would I be able to get agreement from the investment community that the law does not prevent them from making such investments.

MR. LINGUA: I certainly would think so. I would be happy to put all my net worth on the line--I wish it were more--as the sole fudiciary investment manager of your plan if you had achieved that status of funding, if you had communicated to your pensioners--not just the ones that are already retired and are more interested in housing--but the ones that are coming along ten or 15 years from now that may repudiate this compact if they don't think it was very wise with hindsight. It would be a wonderful world we would get to even if your plan was not typical, I would hope it would not be the only one around.

MR. TOWER: Let me just take it one step further down the road. What do you do in the situation where actuaries are telling you that a six percent return on investment will allow you to meet funding standards of ERISA. You're looking at your entire portfolio. Your entire portfolio is making a return of six point two percent, for a given year.

MR. LINGUA: That's irrelevant. What it's done in the past is what it's going to do in the future. That is the only relevance in relation to that objective.

MR. TOWER: Yes, except you use the past forecast for what it's going to do in the future.

MR. LINGUA: If you want to get into a real trap, you do that, yes. And when everybody agrees on something like inflation has been cured, it will be because inflation has gone down to one percent and is right on the verge of escalating up within a year or two.

MR. TOWER: Aren't you forecasting -- aren't you making a forecast on the basis of past experience every time you make an investment decision?

MR. LINGUA: If everyone agrees on something, count on the opposite happening. And your actuaries will not agree. No actuary that I know--and they're not all as distinguished--will agree with you, the premise you made, that six percent is going to take care of everything.

MR. FRIEDES: I'm an actuary and you could not accept that statement as he said.

MR. TOWER: You could not accept that?

MR. FRIEDES: You would not say that statement. An actuary would not make your statement because there are considerations beyond the interest rate. There are many factors and there're all analyzed in combination. Further, the actuary shouldn't have anything to do with investments. They should not dictate it, and what the project should be irrelevant to the managers. The actuaries are estimating what will happen. The investment manager and the the trustee should work on how to achieve the maximum return, without regard to the actuaries estimate.

MR. GLOVER: You asked for comment from those that would accept less return in order to achieve other objectives from an investment. Let me cite some of the areas in which I think it could be done. Take the plumbing or pipe fitting union, or sheetmetal workers, where they know that as soon as solar energy comes into its own, there's going to be a lot more people working and organized and it's going to help their organization.

I can see them bending their investments toward the solar energy program. And I don't see anything wrong with that. As in a multi-employer pension plan where we have all union employers who are participating in the program, I don't intend to take, as a trustee, money and invest it in a non-union company. That would be against my own best interests. And, I'm going to find a union company whose return is good. And I think I can find that. And if I have to take a percent less, or whatever, in the long run you come out. I can make a good argument that in the long run we would come out on it. And the same thing has to do with employment. I think that if you know there's going to be more employment as a result of your investments--the housing industry is a good example--then even though you may take a little less return, its worth it because it improves the economy of the company and in the long run I think it's going to improve your overall investments.

So I see areas where you can make those lower return investments. I understand that they're fought with all kinds of problems. But my experience has been that those who advise me now don't do as good as the market. And if we indexed our

fund, it would do better than what I'm being advised. But I don't hear no hue and cry about that. Nobody says anything about it.

Well, I think that we can take these social factors into consideration. And I think we're just as good at forecasting as they are. The only kind of forecasters I know, as I mentioned before, are two handed economists. On one hand, it will do this and then on the other hand it might do this. So I don't find myself discomforted with that at all.

MR. SCHOTLAND: Two points. These hypotheticals like housing in the same area as the plan. It may be 100 percent of the beneficiaries will live there, but I doubt it. The nature of retiring, unless you start out from Arizona, is to go to Arizona or to Florida. And back in the trust law I come from, unless 100 percent of the beneficiaries agree to the variation you don't deviate from the original trust understanding. So I just don't see that one at all.

Before talking about this marvelous fixed income performance, you should look at chart one and two in my paper. They show absolutely ghastly fixed income returns. And you can pick your period. You can go to chart three and you can take T-bill returns, or you can take chart two which is inflation adjusted and you can pick out your low inflation periods. It's absolutely awful.

In this past year Ginny Maes have out performed fixed income a little bit. The high grade corporate bond index on Solomon Brothers is down five and a quarter percent in the last 12 months, Ginny Maes are down only four percent. So it's all a very nice yield but yield doesn't buy any bread, it's total return that does, and total return is getting eaten up. These hypotheticals really bother me about investments that aren't there, such as senior citizen housing in the same area. Mark Gartner, a Toledo Taft-Hartley lawyer, has a marvelous demonstration on the realities senior citizen housing.

There are two realities that really bother me. One is it's a very good vehicle, the union labor life insurance company has a "J for jobs" account aimed at union construction. The total amount of the biggest construction union pension funds is about two and a half billion dollars. The total amount of Taft-Hartley is, I don't know, about 50 billion, 70 billion. The total amount which has come from all the social consciousness in the "J for jobs" account is 27 million.

MR. SMEDLEY: Well, the AFL-CIO has a mortgage investment trust which is an alternative.

MR. SCHOTLAND: Total amount?

MR. SMEDLEY: I don't know.

MR. SCHOTLAND: Don't know. Don't know because there's much more interest than there are facts. We don't even have the facts about it. And I submit there's a real problem.

MR. GLOVER: You see, we haven't done enough.

MR. SCHOTLAND: Yes sir, But one of the most disturbing things I've heard here--and you'll be taken to court and you'll have your pants sued off--the statement that you're going to do this with as little visibility as you can. If anything is relevant of the accusations made against the trust managers, it is that. We need full disclosure. The minute you start deviating from full financial returns, you need even more disclosure. And let your members see whether they buy it.

MR. GLOVER: You're under the assumption that our President's advise is better than that.

MR. SCHOTLAND: Sir, you only said you don't want to do this out too visibly. Whom are you protecting from whom?

MR. GLOVER: Oh, I'm talking about in front of people like you.

MR. FRIEDES: We have one consensus item: that investment management policy should be directed toward serving the participants as participants. I'm wondering if we can move it a step further. Do we have a consensus that under equal return expectations there can be, under certain circumstances, or will be as a matter of the way people work and trustees work, selections along the lines of social, political?

Anyone disagree that it will in fact will happen?

MS. FERGUSON: Oh, no.

MR. FRIEDES: We agree then that when you have an equal choice of two investments, and you feel they're equal, you do just as Mr. Glover has said: you make a choice tied to union status if it's that kind of a fund. They may make it on some basis that may help participants. That's a valid thing to try and think about. Or, housing in the area is certainly a valid thing to think about assuming you're not accepting any lower return at a given level of risk. Is there any problem with assuming that if you're directing yourself toward the financial goal which is within the Jim Hutchinson definition, that it will be okay to make some selection that will have as part of its post financial criteria some of these things we've been talking about? Can we agree on it? Anyone disagree with it?

(No response)

MR. FRIEDES: We may have made some headway in our disagreements. I think the real area of disagreement is whether you're willing to take less return. If you can cut through all of the discussion that we've had, I think we have disagreements when we move off financial criteria. As soon as you get off the financial criteria you're in a no man's land and the investment manager has an enormously difficult situation. And, people who are evaluating investment managers have an enormously difficult situation. You get into the issue of who decides what, what are your implementation rules, and who's going to make those various decisions. And that's when I think everyone has the enormous degree of difficulty.

MS. FERGUSON: Can we back up for what I was trying for which is a step before that, a long step before?

MR. FRIEDES: Go ahead. We're now summarizing.

MS. FERGUSON: I'll try once again. Rather than Jim's position that you can take these considerations into account, I would argue that when the trustee knows what the consequence is going to be, and that the evidence is irrefutable that it will undercut these participants pensions, you must take factors into consideration and must not make that investment.

MR. SMEDLEY: Can I interrupt? I think there's some clear-cut cases. Public employee funds which are very large can help

keep the investment in that state or in the industry, which is to their great advantage. For example, don't you think the New York pension funds should have invested in New York? They played a major role in making an agreement so that the Federal Government would come in and put up the funds. The Federal Government wouldn't have done it without the union funds. They got good rates of interest and probably will make out. But even if they hadn't gotten the prevailing rates of interest, it was to their interest, to the city and to their jobs, to do so. I think that's one clear cut case.

What do you do in the case of a local union construction fund with high unemployment in the area? Without jobs you don't get the contributions for the fund, and you'll be in trouble in that fund. Don't you think it makes sense for that fund to invest in that area, even at lower rates of interest, than to spend the money and send it off to New York -- or Atlanta?

I think there are clear cut cases where it makes sense for a pension fund, in the interest of its members, to take a lower rate of interest. Such situations are pretty obvious. I don't think you can lay down a clear cut rule and say you should never do that; you should never accept a reduced return.

MR. FRIEDES: In the specific situations you're naming, you'd probably get an overwhelming consensus of participants. It wouldn't be a plurality among five different alternatives -- the biggest vote might be 20 percent.

MR. SMEDLEY: All right. But you'd probably get an overwhelming consensus if you took a vote in an auto factory or in Boeing as to whether their pension fund should invest in non-union companies, too; you'd get an overwhelming consensus.

MR. SALISBURY: Larry, let me ask you a question on tnat. The fund where the choice is to put assets of the plan into creating employment. Let's take a hypothetical, and there are plans that would fit it, where retirees out number active workers by two to one, and where the current level of assets in the plan on a termination basis would be fully adequate to meet the benefit payments of every current retiree. In that kind situation how the circumstances change? And how obvious is it that you'd be able to get thar kind of consensus? I don't know that you would be able to get a concensus particularly if the plan is relatively mature and retirees are in the majority.

MR. SMEDLEY: I mean, you may not get an overwhelming consensus and you might not be able to do it. But I'm interested, Dallas, in your assumption by implication that the decision should be made by the participants. And if you are accepting that principle by implication. In most cases the decision is made by trustees who don't take into consideration the wishes of the participants, whether it's overwhelming or not. It may be done on the basis of the recommendation of an investment

advisor. So I'm saying in some cases you may not be able to get overwhelming consensus. At least you are conceding that the participants should play a role in making that decision.

MR. SALISBURY: I'm not sure I am, but I think that was your assumption leading into it.

MR. SMEDLEY: I was trying to put words into your mouth.

MR. SALISBURY: Yes, I caught that.

MR. FRIEDES: Roy.

MR. SCHOTLAND: One fact, one observation plus fact. The one fact is that as of '78 there were 1,129,000 active in the New York City funds, 309,000 retirees. You have to add to that 309,000 and reduce 1,129,000 by anybody within whatever years you want to set of retirement. These persons are surely thinking much more about retirement, in light of their job seniority, than they are about jobs.

The observation and fact is that almost whenever you find something that everybody's confident in or participants would agree to, the odds are you're reinventing the wheel. It's happening. Take the New York State investment as an example. I've argued against the hypotheticals that are, in my judgment, like what I described as the old cardographic problem of drawing the map of Utopia. They don't exist and can't. The hypotheticals, they're actuals and we don't need to argue for them. In New York State, they have 11.5 billion dollars invested in 228 corporations. About 25 percent of those equity holdings have New York corporate headquarters. About 40 percent of the corporate holdings have New York manufacturing operations. About 13 percent of the corporate holdings have retail facilities or specific sales facilities in New York State. And the FHA mortgage portfolio is 31 percent in New York State. So what are we arguing we want them to do?

MR. MAUHS: Those investments are solely the result of traditional financial investment decisions, Roy.

MR. SALISBURY: Based on what?

MR. MAUHS: Based upon normal fudiciary concerns.

MR. SCHOTLAND: I didn't mean to imply otherwise. I was assuming that, knowing the people involved.

MS. FERGUSON: It's just a clarification point. I think because of the conflicting interest we're really going to have to talk about a consensus of actives, plus a consensus of the retirees, having them polled separately. The interests are distinct. I think the interests are equal but different.

MR. ANDERSON: Peter, let me offer an observation. When we talk about the nature of the property rights of the partici-

pants a feature that stands out--and I think confuses our discussion here--is that the property interests of the participants and beneficiaries are undivided. Whenever you place a fudiciary or a trustee in a posture where you're suggesting to him that he take some action that will advantage one group and substantially disadvantage the other group, the trustee is going to be in a very difficult posture. I would suggest that whether we're talking about substantial agreement of all the participants or just agreement of the actives and the disagreement of the retirees, or whether there's no more than one hold out, that that one lone participant who disagrees with the actions that the others choose to take may very well have rights under ERISA. Even though his property interest is undivided, he still, nonetheless, will have a property interest and can sue to protect it. The fudiciary is in fact obliged to protect his property interest and his enjoyment of it.

MR. FRIEDES: Mr. Harrington.

MR. HARRINGTON: Yes. I'd like to bring everybody back into the real world for a minute about finding a consensus among participants and beneficiaries. I would like to ask around the room how many people have discussed any of these issues with beneficiaries? If you're fudiciaries, how many have actually done to their beneficiaries and tried to gain a consensus or some input from their beneficiaries? I know, at least in California, we're looking at 180 public employee pension plans administered by 165 separate agencies. Very few have ever even attempted to communicate with their beneficiaries. And in fact, the overwhelming majority have never even sent out an annual report.

But what I'm getting at is if you want to talk about trying to talk to your beneficiaries, then you'd better talk about the real world. How many plans have attempted to discuss these issues with their beneficiaries.

MR. MAUHS: Do you know what he's talking about.

MR. FRIEDES: Sure.

MR. MAUHS: I can give you such an example. We did it recently in the State of New York. Some four or five weeks ago we sent out a semi-annual bulletin to our members and pensioners. In that regular issue we explained the state comptrollers policy not to consider social investments in the investment decision making process. We suggested the possibility of a proxy voting mechanism to recognize social concerns after the investment is made. The response, which we really didn't expect, has been overwhelming from members and pensioners congratulating the state comptroller for taking that position and urging him not to consider social, moral issues in making investments.

We had one nay sayer, a lady from Long Island who told us not to invest in Booker Chemical. Well, we didn't hold Booker Chemical.

MR. HARRINGTON: I think that that's a real start, but I would say that that is the exception rather than the rule.

MR. MAUHS: Well, it's the real world, it happened.

MS. FERGUSON: How did you describe and define social and moral investment?

MR. MAUHS: Well, this was not a questionnaire. We weren't soliciting.

MS. FERGUSON; No, no. How did you state your decision. If you said to me that you are not going to invest pension assets according to your moral views, I would say fantastic, because I don't know what your moral views are. I mean, it was a question of how it was stated and I would have probably applauded you, too, if it were stated in that way.

MR. GLOVER: I'm going to tell you about another world because I live in a different one. We brought this program up possibly two years ago in front of our leadership and asked them to get some opinions on it. When we first brought it up it was radical. We hit the issues like non-union companies and EEOC violators. We went the whole bit and they stood up and applauded. They thought it was great. That was their pension we were talking about. And we said, yes, we know that's how you feel because you're top notch. But how do the people feel about it? And they wrote back and the people felt the same way. Now, you know, we may be living in two different worlds. I suspect we are. But don't think that your world is the only world, because our people think it's a damn good idea. They don't like to see their money invested in people who violate OSHA, people who are anti-union, or non-union companies. They want their money invested in their best interests, and we look on that to be in union companies and in people who live within the law.

MR. MAUHS: We've got different clients obviously.

MR. GLOVER: Well, I also think we have differences in the statistics concerning who's the violator, and other things.

MR. FRIEDES: I don't see your name.

MR. BALDWIN: Just a general question for the room. I'm familiar with a study done in the late '60s of investors in one of the Wellington mutual funds. It overwhelmingly indicated a willingness to accept a diminished return if some defined social goals were realized. Is anyone here familiar with any recent indications from a particular group involved in a financial institution indicating their opinion as to whether or not they have any interest in social concerns? Second, whether there was a question of risk and return and how the opinion came out.

MR. FRIEDES: Ken, can you answer that?

MR. KEENE: Yes. Our firm commissioned a broad survey by Lou Harris Associates on the subject of pensions and retirement. This was conducted in August of 1978. One of the questions asked of the respondents was: how would you react if your pension fund monies were invested for social purposes? We used South Africa in the question, for example, although we talked about companies or countries that might be practicing socially undesireable policies. The question was asked two ways. One: would you be in favor of investments being made in a social direction? 47 percent of the participants questioned said they would be in favor of it.

When the question was rephrased -- and this was asked only of those who were in favor of it--would you be willing to accept lower returns and lower benefits? It was something like 80 percent of the original 47 percent who said yes, or 36 percent of all those surveyed.

MR. TOWER: Even if it decreased their pension?

MR. KEENE: Yes, for 36 percent of the participants.

MR. FRIEDES: Mr. Bisset.

MR. BISSET: Mr. Smedley provided a very interesting example which seemed to enjoy some acceptance from the group. There was an office building being constructed in an area where it created employment, and the rate of return was only somewhat reduced from alternative investments.

I would caution the group, at least from my perspective that when we're talking about reduced rate of return we're really talking about very small numbers, very small latitude. And would the group be content with the theory that if you can accept a somewhat reduced rate of return with or without consent of participants, beneficiaries client sponsors, can you consciously accept no return or even more absurdly, can you accept a negative return? The investment would still be good for the union, for the particular area, but producing not only no return for the pension fund but a negative return. As an attorney, I would not want you as my client if you were going in that direction. So reduced return, how much. Isn't it all a question of degree which must be very carefully watched?

MR. HARRINGTON: Again, what is your definition of return? Is it rate of interest? Is it maximum yield? California has no definition of maximum yield or highest yield in the statutes.

MR. BISSET: I agree, and I would not be able to tell you what a maximum yield is. But if you consciously went into an investment that you knew was going to produce a very inferior yield to the expectations of the funds and achievements of the funds, or no yield, or even the further example of slightly

negative yield, I think you may have a problem.

MR. HARRINGTON: But the point is if there's a consideration of factors that make up total economic yield, then that in and of itself is --

MR. BISSET: I'm not sure we all buy your definition of total economic yield.

MR. HARRINGTON: Yes, right.

MR. BISSET: You may be a little ahead of the industry.

MR. HARRINGTON: But that would be a very progressive move. In the context that you mentioned I think we have moved a long way from the pure but very narrow sense of viewing the highest rate of interest as financial return.

MR. BEERS: The thrust of what we're talking about here seems to me to come back to the question of matching the issue of the assets, which is what the central thrust of our discussion is, with the liability for the plan. Coming into today's meeting I couldn't imagine a situation in which a lower rate of return would be acceptable for "social purposes".

But as I think about this, it strikes me that we make decisions relative to risk which have a much wider probable rate of return impact than the spread that we would be talking about between one form of "social" or "non social" investment from a relatively similar investment. In other words, if a fund wants to invest at a lower rate of return in a mortgage in a particular area, compared to a comparable bond, the number of basis points between those two investments is probably miniscule compared to the basic level of risk that's imposed by the overall equity structure of the plan. Given that, it strikes me that the real issue is whether benefits can be paid? Can we meet the liabilities of the plan under the particular investment policies that are being suggested? And if the answer is yes, then perhaps some form of modest dimunition is acceptable.

In answer to the question of the extreme case that the investment has no return or negative return, I would suggest that the answer is again obvious. A likelihood of paying benefits with a negative return is very small and, therefore, it's clearly inappropriate.

MR. FRIEDES: Don Smart.

MR. SMART: I just want to make some brief comments in response to a couple of points that have been raised. To Mr. Bisset's comment, I would posit an investment that has a phenomenal return, but the employees know that 50 percent of them are going to lose their jobs when it's made. The other 50 percent will have a very fine retirement. And I think you'd have trouble getting consensus for that kind of an investment.

MR. BISSET: I have great problems with the consensus approach anyway. I think it's possible. It hasn't been tried, that's what makes it difficult.

MR. SMART: On the private side, one investment alternative that I think is very socially responsible is the ESOP. I wonder whether that kind of a concept would be appropriate for the public sector.

The ESOP concept is being pursued by Chrysler right now. There's a lot of risk for the employees in that case, but it's a possibility that it is in fact permissable under ERISA. I think you'll find that there are many exceptions to what we have been talking about as the prudent course under ERISA. And I'm curious as to why they're exceptions.

MR. SALISBURY: The ESOP is not a retirement plan as normally defined, and assets of a qualified pension plan never get invested in a corporate ESOP. It does not seem relevant to this discussion.

MR. SMART: In Wisconsin I took a public sector survey. Admittedly, not nearly as precise as Lou Harris, but it occurred at the same time and I was struck by the similarity in results. One is that what the employers thought was sufficient information for the employees and what the employees thought was sufficient information were quite different. The employees felt they were not getting enough information, the employers seemed to think they were getting more than enough.

In the poll that I took I stated a social investment question: as long as the investment manager is earning money to pay retirement benefits, would you favor consideration of other alternative economic advantages?

It was interesting to see that there was an overwhelming percentage for considering other things. We did a control survey of the general public. The results were in favor of other types of investments. It was overwhelming in both cases.

Finally, Roy commented that retirees in Arizona would not get a voice.

At a recent conference one attendee stated that he knows without a doubt that his grandmother that lives in Arizona would gladly give up her pension to make sure that her relatives that were living and working for the State of Wisconsin continued to have their jobs.

MR. FRIEDES: Roy.

MR. SCHOTLAND: Here's a question for John Harrington. And in asking this I'm violating the first rule of cross-examination because I don't know what the answer is going to be. But it

isn't a trial even if I get it in my own artificial hypo about suing Mr. Glover, which I would never do.

What about the three unions in Sacramento and the organization of retirees who said we don't want none of this social investing? Weren't they heard from?

MR. HARRINGTON: I would agree 100 percent with the one individual that represents the retiree association and the labor people. If you look at the specific letter they signed, you'll see that social investing is very broadly defined. And it was not clearly defined, as it has not been here, because we seem to think that they're purely financial decisions in returns. And social and political is something out there that is sort of removed from the financial and investment decision. And I would put it to you that that is totally in fairy land and totally removed from the real world. When we make an investment we look at all these factors. That's why organized labor as well as financial institutions and large corporations, including the California Manufacturer's Association and Chamber of Commerce, have spent a great deal of money in Sacramento to make sure that the investment standards that are in the statute are very limiting regarding the way capital flows from public employee plans to the private sector.

MR. SCHOTLAND: The letter did explicitly say we sincerely trust the Board will continue its sound investment practices to produce its results, right?

MR. HARRINGTON: That's right.

MR. SCHOTLAND: They called for no change, right?

MR. HARRINGTON: Social investing is broadly defined, very much so.

MR. SCHOTLAND: They were for some change?

MR. HARRINGTON: I don't understand. You said social investing. Social investing is very broadly defined to include a number of things including South Africa, including low income housing, that and that only.

MR. SCHOTLAND: You know more than I do but we seem to have some differences about the facts.

MR. HARRINGTON: The Board of Trustees unanimously accepted that document in saying that that should not be the exclusive purpose of investing public employee retirement retiree funds.

MR. FRIEDES: I find it very difficult to spend seven hours here and not editorialize it all. Being moderator is a terrible handicap. And I therefore want to spend at least one minute of comment, but I see Karen has her name card up.

MS. FERGUSON: I have a concluding remark.

MR. FRIEDES: Go ahead.

MS. FERGUSON: Well, I'll go after you.

MR. FRIEDES: Oh, you want to be last.

MS. FERGUSON: Yes.

MR. FRIEDES: Okay. I just wanted to give a prognosis of what I think might evolve. And that is I think that when we get beyond equal financial expectation, we are treading on very, very thin ice. But, the umbrella of equal expectation is a fairly broad umbrella. I really think we can accomplish quite a few of the things that Mr. Glover was saying earlier. We'll sort of creep into making choices that make sense to the people who are making those choices. And in fact, that's what's going to happen because it's natural, it's human, it's nature, it's what people are. They have the obligation of making those decisions and they're going to make them on the basis of what makes sense to them. I'm sure we will creep into some forms of "socially sensitive" or "moderately divergent" investing as it naturally evolves. I think that if it ever became legislated in any way it would be a disaster in terms of being impracticable, unadministerable, or horendously costly to everybody in every plan. Suddenly the retirement security of lots of people would be endangered.

I think everyone here came because they care about participants and participant's security. I have a feeling we'd better creep in there rather than racing there.

MS. FERGUSON: This is a personal note after reading Roy's paper, staring at this term "divergent investment", and reading all of his historical and literary analogies which are so nice and professorial. I was bothered by the term "divergent investing" until I remembered one of my favorite poems when I was young is, of course, the Robert Frost poem which starts out "Two roads diverged in the yellow wood" and it ends "And I took the one least traveled by, and that has made all the difference".

So I decided it's not such a bad term afterall.

MR. FRIEDES: It's not so bad after all. Well, I think this has been a very valuable session. I think all the papers are valuable, and the bibliographies by themselves are extremely valuable. We will publish a book from the forum that will be valuable.

On behalf of the Employee Benefit Research Institute I thank all of you for coming.

Asset Ownership, Plan Type, and The Efficient Market

MR. FRIEDES: Larry Fisher.

MR. FISHER: I just wonder if I'm the only one in the room that's having trouble with Karen's posture that this money is exclusively and forever more the employee's money, I think the responsibility of the actuary to report in representation of the plan participants and determining the liabilities must be understood. Quite apart from the trust document that Roy referred to, we have ample evidence that a plan sponsor has an obligation to fulfill the commitments that have been communicated to participants. So that over here are liabilities that are established independently by the actuary representing the plan participants and irrespective of the trust document, the company has an obligation to provide those benefits.

Now it seems to me that this gives the sponsor company some interest at least in those pension reserves. It's just not as simple as being "pure and simple employee money" as it would be in a defined contribution plan where most employers that I know of give an employee a wide option of selection on investments. I just don't quite accept that blanket concept tnat this is all employee money and I wonder if I'm the only one?

MR. MAUHS: My name is John Mauhs. I administer the two state retirement systems in the state of New York. And Mr. Fisher, you're not the only one. I have a great deal of difficulty with the generalization that the money, the fund, belongs to the plan participants.

Admittedly I speak from the perspective of large public retirement systems. It's my position that the participants don't own these funds. They can't withdraw the funds, they can't borrow the funds, they can't direct the use of the funds. Indeed, these are trust funds. I also have difficulty with the statement that the funds represent a deferred wage. It's the pension that is the deferred wage, not the fund itself. The fund, of course, goes to support the pension when it's pauable to the individual, when he retires. In the state plans, in the public plans, there are constitutional and statutory guarantees to these members that the benefits that they have worked for, that they have earned and accrued may not be diminished or impaired. So if the

administrators of the fund invest unwisely and there are losses sustained by the fund, the member is not at risk, the taxpayer is because indeed it is the taxpayer who's going to have to pony up in that case.

MR. FRIEDES: Mr. Leibig.

MR. LEIBIG: Just two points. One, it's far from accurate to say that in state funds and in large state funds that there are constitutional and contractual guarantees that mean that the benefits will be paid regardless, I assume, the implication of the performance of the fund.

In some states there are such protections, but in a great number of states there are no such protections and there's very few places where such protections have ever been effectively enforced. New York has an unusually strong situation, it's not at all typical.

But more importantly I think the question of whether the funds belong to the employees or belong to the trust or belong to the employer, which I think are three different possibilities necessarily, is a little bit of a red herring. I think the statement that the funds don't belong to employees but, "Belong to the trust", is one statement. But the statements that they don't belong to the employees, rather belong to the company--and again, I don't like the language, I mean, it's all not very precise--is misleading.

I think Karen's statement that the funds should be viewed as being the property of or belonging to the employees is meant to say that they are in trust for those people.

MR. FRIEDES: Is that true, Karen?

MS. FERGUSON: I would certainly say it was a little bit more than that. I would say that there's money that belongs to the worker, he has to stand by that, they are beneficial owners of it. The analogy is simply that it is a personal trust, which is where all this came from.

I set up a trust for my son and I appoint Peter to administer it. The money does not belong to Peter. It no longer belongs to me, if it's a derivatable trust. It belongs to my son. It is being administered as a matter of convenience because my son is only seven and three-quarters years old and he cannot administer it himself.

That is where the pension trust concept came from originally. It was the notion that you had a large number of people who were not in a position, for a variety of reasons, to manage their own money.

Now I'd like to answer Mr. Fisher before he talks again. Specifically, first as far as private plans go, Senator Javits stated shortly after ERISA was passed that if there was one thing that ERISA did, it confirmed that pensions were the deferred wages of workers. It put an end to the gratuity theory, the notion that this is employer money. I assume that you would say that a defined contribution plan -- does that belong to the employers?

MR. FISHER: A defined contribution plan is a separate issue entirely.

MS. FERGUSON: No, I would say it is not. If you accept that the money going into the defined contribution fund, once it's in the fund, belongs to the workers, then I think you have to say that the same is true in a defined benefit plan.

All that you're talking about in the defined benefit plan is an arrangement which is for the convenience of employers to meet certain benefit objectives. Namely, to pay the past service credits and to provide a benefit that is either career average or final average based. For that reason, it has a number -- it has this pooling element, an you forfeit your elements to it. But those are to serve certain specific benefit objectives. It does not change the nature of the money that has been put in and has been taken out in effect from take home pay, that has been put in a fund to be pooled, to be given to some participants.

I don't see how you can say it does not belong to the workers.

MR. FISHER: I have no qualm with your statement that it's deferred wages. The pension is deferred compensation in every sense of the word. But your analogy with your son is far removed from what we're talking about. Your son does not have in his possession a computerized benefit statement carrying out to penny accounting what his benefit will be when he develops certain specific commitments, some of which he likely has already fulfilled.

That is the compensation part. That is the deferred wage part. The moment that you make a commitment to your seven or eight year old son that when he fulfills certain contractual obligations he will receive a deferred wage, that seems to me is a dramatic difference between the personal type trust situation you're talking about and a commitment that has now been interpreted, irrespective to trust, to be a legal commitment of the employer to indeed provide the benefits.

MS. FERGUSON: Why does it matter? My trust provides that he will get control of the money only when he is 25 years old --

MR. FISHER: He'll get the proceeds, whatever the proceeds are.

MS. FERGUSON: Yes, exactly. And that is merely one condition, he can't get a hold of that trust.

MR. FISHER: So you've established a defined contribution plan for your son.

MS. FERGUSON: Oh, well, we'll pool it and whoever, you know, scores 30 on some test or something there'll be three sets.

MR. FISHER: But, Karen, you won't accept the fact that if you've made a commitment to your son that you will pay him $300.00 a month beginning when he reaches age 10, irrespective of what happens to the corpus of that trust, then he has a deferred wage that you have given by a deferred compensation program that you're now liable to fulfill.

That I think is the significant difference.

MS. FERGUSON: You're mainly saying that because for his own convenience the employer has chosen to pool this and make the commitment. I mean, every employer has the option of putting in a certain amount each year or of going the defined benefit route.

All I'm saying is that the cleaverness of the actuaries who originally designed this defined benefit plan and arranged this concept, this pool thing, does not change from a trust law perspective the nature of the money that is in that pool. Mr. Paul, can you help me out?

MR. PAUL: No, I disagree with you so I wouldn't help you.

(Laughter)

MS. FERGUSON: I see no difference in the money that has gone into the fund in a defined benefit or defined contribution plan. I think that's what it reduces to. If you conceive that the money going into the fund is taken out of take home pay of one or more employees, then that is deferred wages when it is sitting in the fund. The fact that you have a pool arrangement for other purposes makes no difference, it is also deferred wages going into the fund.

MR. FRIEDES: Mr. Paul, do you want to comment on that?

MR. PAUL: I think that the distinction that you're losing sight of, Karen, is that in fact in a defined benefit pension plan in many, many situations, the corpus will never be distributed. And if you decide to convey property to your child in the form in which you decide to convey the corpus to that

child, that's one thing. But a defined benefit plan is a situation in which you are pooling contributions to support benefit expectations. And in an earlier model when inflation was not as rampant as it was, we used to describe to people that in fact the contribution will build up over time to reach a level where the corpus 30 years or 35 years from now will be a certain size, the income on that corpus and the continuing contributions will match benefit payments and the corpus will never be invaded.

So I would suggest to you that what you're really talking about is a sort of clipper trust in which you convey the property to your son for the period when he needs it. Maybe he needs to get through a certain kind of expenses and the property is not yours and it's not Peter's in your example, but it's only the income on that property that's your son's because you tried to provide for a certain contingency namely a stream of income that he's entitled to in the case of retirement.

That's quite different from a defined contribution plan as --

MS. FERGUSON: But that doesn't affect the nature of the money put into the fund. That's what I'm trying to say.

MR. PAUL: But it's not quite the nature of the money that's in the fund, Karen. No one is arguing that the trust that's been created isn't for the benefit of the participants in the plan whether active or retired.

MS. FERGUSON: Well, I think that's where we're headed.

MR. PAUL: I don't think so. I don't think that's what's being said.

MS. FERGUSON: Isn't that what it's all about?

MR. PAUL: I think there's a big distinction between a fund created for the benefit of a group of people all of whom do not have individual interests in a certain amount of that corpus and a defined contribution plan where each and every participant has a defined savings account so to speak that belongs to them "in the sense in which you can define what their rights are."

The rights of somebody in a defined benefit plan consists of the right to collect the stream of income, not the rights to own a piece of property.

MS. FERGUSON: Well, we could debate this forever.

MR. FRIEDES: Are the people who have the name plates up, how many are directing themselves to the issue of the defined benefit versus defined contribution? Okay. Mr. Ennis.

MR. ENNIS: I think this is a vital issue and I think that until there's a clear understanding of the differences between a defined contribution plan and a defined benefit plan the advocates and the opponents of social investing aren't going to get much closer to any kind of resolution. And I guess what I would be trying to do is to take a stab myself at what the important difference is. And that is that if we're talking about a defined contribution plan--and we'll speak hypothetically--wherein the risk takers are the employees and the company agrees to let them have elections and form a group that will represent democratically all the employees in matters of investing the assets, and the employees choose a course of social investing that is based on other than purely financial criteria in making investment decisions and they lose the fund, they lose their money. They're playing with their money.

The concern of corporate and governmental sponsors and Taft Hartley Boards is that their bearing the risk for these funds. And if the money has been lost, if they turn the fund over to anybody who is going to make investment decisions, they continue to have the responsibility for replacing the money. And whether it's bad traditional investment management, or social programs where investment concessions are made, that the money is lost this year and has to be replaced--of course, it is amortized over some period of time--but dollar for dollar every dollar that disappears gets replaced. And I think until that's clear in all of our minds it's going to be very difficult to understand why pension sponsors and the fudiciaries they appoint get up tight when people talk about granting what we've called in our work investment concessions.

MS. FERGUSON: Can we talk about an equally yield situation and how this bears on an equal yield risk situation?

MR. ENNIS: Pardon?

MS. FERGUSON: How does this question that the employer and I did disagree, as I've said, and I think there are instances in which the participants assume the risk, can assume the risk, but assuming--trying to get this discussion on the track--assuming what Jim was positing of an equal yield situation and what he talked about --

MR. ENNIS: Okay.

MS. FERGUSON: -- as socially sensitive investment, does it matter? If you're not asking anybody to assume a risk, we're not asking the employers or the employees to assume the risk, why does it matter?

MR. ENNIS: Okay. I would like to comment that it is related, but involves in some sense a different issue. Many of us are perplexed by the reliance that's given to this idea of the coin flip investments where everything else is fine.

Roy has referred to them as double X and Jim as the socially sensitive investments. A lot of economists would generally conclude that there really aren't any such investments. That is, they would also conclude that there's never any such thing as capital shortage. Most economists say that there never is a capital shortage. That doesn't mean that almost all of us couldn't use a little bit more money and have a few projects that we could probably make some interesting investments in. But the amount of capital that exists is finite at any point in time. And that is the amount of capital that there is. We have a competitive market for investments. It's called efficient and most of the evidence suggests that it generally meets the test of efficient markets. But investments compete in these markets. And the ones that the amount of available capital wishes to pursue clear in the market place and others don't. And those investments that clear on financial criteria don't need advocates. So it's very difficult for me to presume that there are scads of investments around at the margin that are just as good as the investments that are being made and also happen to have attractive social benefits, but they just aren't being made.

MR. FRIEDES: Randy, I think you were next.

MR. BARBER: Well, Don Smart would be interested in commenting on that. I will defer to him since he's just completed a study. If he doesn't want to, I'll take a crack.

MR. SMART: Thank you, Randy. The efficient market concept is one that's very interesting and it's directly related to this whole argument. I found as I tried to stay in the middle of this issue for the last two years that the advocates did not believe the market was very efficient. And the ones that are against it believe that the market is very efficient. And there seems to be a large body of evidence that I found on both sides. And so I guess I would disagree with the economist to which Richard Ennis refers because Garr Appogitch who Roy Schotland mentioned earlier, disagrees with that assumption. He's done some fairly interesting studies on it and there are economists with the State of Wisconsin who also disagree with the efficient market theory to the point where they are thinking about pursuing the concept of seeing whether they can't implement use of the funds to the benefit of the state, the participants, the taxpayers, and so forth, without increasing the risk of the fund.

I'm not going to get into any more detail than that because I think that this gets off the course of the purpose which Pete said we're still on. I don't know how we're going to get to point nine miscellaneous, I have some points --

MR. FRIEDES: We'll cover quite a few actually.

MR. SMART: But let me take my five minutes because that's what you promised us to begin with and then I'll probably be

quiet the rest of the afternoon.

One of the things that Karen has said which I agree with very much and that is what is the purpose of the fund and that is to the extent -- her first premise that she felt we could be in agreement upon. And that is why can't we make the statement that we don't want to use those pension funds to undercut the employees. And the corollary: why can't we use those funds to a greater good if such a greater good exists. I see so many people here that have a vested interest in providing services to help the financial considerations in terms of making financial decisions. I would suggest that you have a great opportunity if you start to look at some of the social things and provide services that would give accurate measurement. I spent two years talking to an awful lot of people that believed that those measurements can be accomplished. And, they really don't exist right now. We're talking about a very nebulous principal that hasn't been tried in many places. One of the things that I would say in regard to that is that Roy mentioned that in Wisconsin it had been tried to. I might point out, to clarify Roy's earlier remark, that Wisconsin did not stop investing 70 percent of the funds because of the return. This was stopped in 1945 or '46. I would suggest it probably had something to do with the change in the direction of the economy after the depression. It was a policy that had been in existence for 12 years. If you look at Kansas and North Dakota and their state bank, you will find some examples where a policy of trying to benefit the employees without increasing the risk of the fund is entirely possible. They are pretty slim in terms of the evidence, but I think that it's a good enough evidence to at least not cast away the concept on its face. And so, I would go back to Karen again and say, what about her agreement? Can't we have agreement on the point that we don't want to undercut the employees?

MS. FERGUSON: The employee's pension.

MR. SMART: Right.

MR. FRIEDES: I think George Swick was next.

MR. SWICK: Well, I would just like to remind everyone, I think Roy Schotland made a very big point of it in his article, the point is that in a defined benefit plan that is not fully funded there is a residual liability, a residual obligation.

In some cases, it's a legal obligation either because of Title IV or because of contractual agreements with a labor union or contractual obligations of the courts. In a defined contribution plan I think it's quite clear, I think to all of us, that there is no residual obligation.

In a defined benefit plan you can have a situation where if there is a residual unfunded obligation for vested and guaranteed

benefits, the employer is clearly at risk. If the vested liabilities and guaranteed benefits are fully funded, then the plan participants, to the extent they're not vested or guaranteed, they are at risk.

To the extent the benefits are fully funded for everyone vested or not vested, then nobody is at risk. But it seems to me in order to really focus on the question of who suffers from investment performance, you have to look basically outside the plan. Who suffers because the assets of a defined benefit plan are not sufficient?

MR. FRIEDES: Mr. Tower is next and then Mr. Schotland and then Mr. Vaught.

MR. TOWER: Just a short question because I don't like to beat live horses, they kick. On the distinction of ownership of defined contribution plans, defined benefit plans, to attempt to assert that there is a distinction in ownership and, therefore, there should be distinctions in control level is to offiscate the argument under trust law as Karen was saying--and others I think will give basic agreement to--legal ownership as such is in the hands of the trustees.

It may not be that legal ownership is not in the hands of participants and beneficiaries, they have an equitable title to the money. But it most definitely is not in the hands of the employers. The employer has the option of holding out for a defined contribution plan in a negotiated instance, he has the option of setting up a defined contribution plan in a non-negotiated instance as opposed to a defined benefit plan. When that is set up, the employer is saying I am willing to take the risks a, b, and c versus risk d, e, and f that I'll find in the defined contribution plan.

To then go back and say that the employers have made the decision to go to defined benefit because it's cheaper for us in the short run it is to go to defined contribution, and to come back and say but wait, it's not working out quite the way we wanted it to: somebody else is talking about controlling the money, we have an ownership right to go beyond the issues that are at hand. Ownership in this instance is quite frankly irrelevant.

MR. FRIEDES: Roy.

MR. SCHOTLAND: I agree with that last statement. And I think Bob Paul was more kind than he needed to be as is his enviable style about what's being lost sight of in this discussion.

There are two key things being overlooked. One is a revolutionary book written almost 50 years ago; there is barely a

a difference between ownership and control, yet we're talking as if we never thought of the distinction in some of the comments. The other is the distinction between equitable and legal title.

Of course, the trustee owns the assets if you're talking about legal title. Of course, that means the employer owns the assets. If the employer is the State of New York or General Electric or DuPont and is the trustee running the assets. There's no getting away from it if you're talking about legal title.

Of course, the beneficiaries in any of those schemes own the assets if you're talking about equitable. That is for whose benefit are the assets supposed to be controlled? Of course, somebody must control and in the Taft-Hartley plan the employers and the employees have equal say on who shall.

And in my weird view of democracy we ought not to have the system the way we do in corporate pension plans, but that is the way the law is now. There are only three questions, and I get so tired of talking about ownership and control and wish the President's commission had done all the other things that they should have done and should be doing instead of this one. Who decides on what and who shall control, and by what process do they pick who shall control. Second, how is that control exercised. And third, if you're talking about who owns in terms of who bears the risk, then it seems to me George Lingua was absolutely correct, they all bear the risk and the question is stated over broadly. The question is rather who bears how much of the risk.

MR. FRIEDES: I'd like no one additional to raise their plaquard on this one because I'd like to go with people we have now who would like to speak on it and then get to another topic.

MR. TOWER: Peter, if I may quickly respond to that.

MR. FRIEDES: Yes.

MR. TOWER: You're right, there is no question. What I was saying is that -- there is no question. And employers can, to the extent that the employer is the State of New York and therefore is the trustee, to the extent that you have a single employer plan that is not negotiated and the employer is the trustee sure, the employer is legal owner. But the employer is not legal owner as employer. The employer is legal owner as a trustee with the distinct, definite fudiciary obligation to the participants and to the beneficiaries, and obligation which some of us feel--Karen is chief proponent today--is an obligation to do everything for the benefit of the participants and beneficiaries. And so it is a question of control and what you do with it.

MR. FRIEDES: Mr. Vaught.

MR. VAUGHT: Okay. The first remark is with respect to Karen's comment about actuaries. I feel that it has nothing to do with the cleaverness of an actuary. The difference between defined benefit plan and defined contribution, as has been pointed out by everybody before me, is a difference in promise. In a defined benefit plan it is deferred compensation and it is in terms of a benefit stream, as Larry has pointed out.

Defined contribution is in terms of a contribution that year and what happens to the investments is the sole basis on which a person will receive an amount when reaching retirement. You brought this up initially I believe as a prelude to talking about benefits or participant participation in the investment of the assets that you would have participants in the investment of, let's say, a corporate defined benefit plan. Well, I thought that's what I heard and I thought I also heard you saying that retirees could also participate in the management of or decision making of the investments.

MS. FERGUSON: No. I said something quite distinct. I said -- what to Randy's point of view is far too modest a proposal -- that the trustees retain control but that they must, when they know the foreseeable consequences that will either hurt the retirement benefit security of retired participants or help them, then they have a duty to act. That knowledge, I suggested was our problem, the participant's advocates problem of getting that knowledge to the trustees of trying to make sure you were aware there were alternative terrific investments with equal yield.

MR. VAUGHT: Well, I misinterpreted your first sentence.

MS. FERGUSON: I was not in any way saying that the participants should take over from Charles Moran and sit in his office and make that decision. Some people would say that, but that's not my position.

MR. VAUGHT: Well, no. Don't go to the extreme. Nobody wants to go to extremes and what you just suggested might be the extreme. However, you did talk about--at least I thought you did--about setting investment policy. The whole discussion today was with respect to social investing, the pros and cons, and with defined benefit plans. As Mr. Hutchinson has pointed out, there are three parties to the investment of defined benefit assets, not the least of which as has been pointed out in several cases, is the employer or the taxpayer. And they have a right to have an employer earn the best possible yield and reduce the cost thus giving a chance for future benefit improvements. And if we're defining, which I think I got at the beginning of this thing, that a social investment is equivalent to a lesser yield?

MS. FERGUSON: No.

MR. VAUGHT: I know, I know. I'm saying that that's the way this meeting started out and the desireability. And then

several people pointed out, all other things being equal and one has a socially desireable trait to it, what's to prevent us from doing that? I think the answer clearly is nothing to prevent you from doing that. But very seldom--and maybe this is where I'm having trouble with what is the definition of social investment--have we seen a social investment with the same yield and the same risk, if there's a risk, as a non social investment or a pure economic investment.

MS. FERGUSON: The area in which I was seeking consensus did involve what I think we all agree is the easiest issue, the question of equal yield. And all I was saying is that if we can reach a consensus that retirement income security should not be undercut, should be enhanced, we've gone a long way in saying that this is the first step, social investing is appropriate.

I'm not going further today. I might next year when we reconvene.

MR. FRIEDES: Vance.

MR. ANDERSON: Let me just offer a quick observation and say that I think I agree with Karen as much as that might prejudice her case. I know I agree with Roy. It seems to be that the argument about who owns the pension assets is, at the one level, irrelevant. And I will apologize to anyone I may offend in saying that. And the second level has already been resolved in the context of private plans. But we have a curious kind of ownership. We have a series of property interests that are created. The property interest that's vested in the participant and beneficiary is sufficiently close to ownership that we might just simply say that we will use the term ownership as it's close enough to representing a case for at least government policy purposes.

But participants and the sponsors, as well as the participants, have an interest in the success of the investment strategy of any plan. And it would seem to me that whether we're talking about a defined benefit plan or a defined contribution plan, a well funded defined benefit plan as opposed to one that's not well funded, the sponsors as well as the participants all have a deep seated financial interest in seeing the investment strategy succeed.

Now whether you have a defined benefit plan that's over funded perhaps, nonetheless, it would seem to me rational to assume that if the plan were to continue to enjoy what might have been unparalleled success in its investment strategy, the participant might well look forward to increased benefits. The sponsor would clearly look forward to continued lack of pressure on his P and L. So it seems to me that we really can't distinguish between the ownership interest, and I don't think ERISA distinguishes the ownership interest between defined benefit and

defined contribution plans. It's true, as Roy nas suggested, that the risk of a particular action might be different in different kinds of plans, but the interests don't really change. The exposure may change, but the property interests themselves don't change.

MR. FRIEDES: Dave.

MR. KUDISH: I think that the issue of ownership is not totally irrelevant. I think that discussion of ownership implies a right to exert some form of control over how the investments are made. An employee in the basic personal trust sense has beneficiary interest in the income flow. I think the question is the remainder of that interest. I think that's relative to some things Mr. Paul was saying. If a plan terminates, and a corpus is sufficient to satisfy all of the obligations, am I incorrect in assuming some of these assets could be returned to the plan sponsor? And if so, isn't that an implication of some form of ownership?

The second question is if a pension is actually equated to deferred wages, then isn't the concept of, let's say, ten year vesting illegal? Doesn't it violate that concept? Because, if somebody wants to leave after nine years they're not going to get deferred wages. So I challenge whether that deferred wage concept is totally correct. And third, we talk about employees in this context so much as a single class and yet under plan termination I think there are various levels of who would get what first by reason of vesting and so forth. I think these are other issues that relate to the act itself that haven't been fully addressed yet.

MR. FRIEDES: Okay. Let's try and leave the defined benefit versus defined contribution and let's try and leave the who owns it and who controls it. Just picking up on Jay's comment, I don't think there's anyone here that disagrees with the concept that the primary guideline of investment management is acting in the best interest of participants.

If there is, raise your hand. As participants?

MR. STEGNER: As participants in pension plans.

MR. FRIEDES: As participants.

MR. STEGNER: Agreed.

MR. FRIEDES: I don't think there's a dispute about that sentence. I think it's only whether you just manage it using the financial criteria that along is sufficient to meet that investment management criteria. Or do you have to go further to meet that investment management criteria. I think that's where we should get the debate to, because we don't disagree that we're trying to help the beneficiaries and the participants as participants. I think we've covered our first two topics.

Pension Plan Termination Insurance

PENSION PLAN TERMINATION INSURANCE

MR. SWICK:

The Institute had a forum in June on the problems of Title IV of ERISA; plan termination insurance. We explored whether Title IV could be made to work. Could it cover the entire private sector? When is a pension earned? When and under what circumstances should a pension be guaranteed? Who should pay for the guarantees? And who is truly at risk?

Now it seems to me in the Federal, state and local retirement systems, it is basically the tax payer who is at risk. When we get into the private sector, we have three kinds of pension plans. We have defined contribution plans where clearly the plan participant is at risk. We have single employer defined benefit plans and we have multi-employer defined benefit plans. At the present time, as you all know, Title IV of ERISA is not applicable to the multi-employer plan area. But presumably it will become covered. The single employer plans are covered by Title IV of ERISA. And to a large extent, Title IV of ERISA has taken the plan participant out of a lot of the risk that he was in before ERISA was enacted.

Now the thing that interested me this morning is that none of the panelists referred to the relationship of Title IV of ERISA and the risk of the plan participants. I think this is a vital issue when we're dealing with what is the purpose of investing: who is at risk in a defined benefit corporate or multiemployer pension plan under an effective workable Title IV of ERISA. Is it truly the plan participant, or is it in fact the plan sponsor not only on an individual basis but for all plan sponsors collectively?

MS. FERGUSON:

Well, to begin with, speaking for myself, I was focusing primarily on equal yield/equal risk situations where the Title IV issue doesn't come up. I think there tends to be an overemphasis on the part of the employers on the security provided by Title IV. We are particularly sensitive to the fact that there are great numbers of workers who simply because they are not vested, because a substantial portion of their benefits come from recent increases, because they happen to have special benefits which are not insured or fully insured, or simply the

fact that their benefits are frozen as of the day the plan terminates, are not fully protected. I want to register a protest against the assumption that somehow Title IV does wonders for everybody because it certainly doesn't. There is a risk assumed by participants in that situation.

MR. SCHOTLAND:

I agree fairly much both with bringing up the question as one that was not adequately brought out and with Karen's answer to it. I think there are two points as a matter of law; first, the current difference between guarantee and vested due to the phase of recent benefit increases; and second, as we move from the current law to the PBGC Multi-employer proposals, the guarantee level.

But wholly apart from the legal liabilities and who's going to bear the risk, and my point is that the employee is bearing some of it, there are other problems. One is trying to sweeten benefits for existing retirees to stay even with inflation. Not only do I think we could do better on inflation if we had higher returns and, therefore, relieving retirees at risk, but also we could improve the benefits for everybody if we had higher returns. The better the investment returns, the more money in the pot.

I reject the proposition, even at U.S. Steel, that the employees bear no risk.

MR. LEIBIG:

I think it's important to address the issue of who bears the risk, too. But I think at least in this forum today, it's important in looking at that question to concentrate on how it impacts on social investment. I think that that question is not as simple as it first might appear.

Let's presume that the employer bears a good part of the risk. Let's presume for a moment that the employer bears all of the risk. If he does, then it isn't incumbent upon the Board of Trustees to invest in stocks or other investments to help that employer since he's the ultimate insurer of the benefits. I mean, in a way that risk can be used in favor of an argument for divergent investment. Let's say it's a coal company plan and all the risk is on the coal company. Then maybe it makes sense for the trustees to invest in the kind of securities or stocks that will help those companies. My only point is I'm not sure that it furthers anything in either direction, any argument about social investment as concertrated on risk.

MR. HUTCHINSON:

We attempted to deal with this issue somewhat in our written analysis, Chuck and I. The interplay of company guarantees in

Title IV and the design of a plan, the difference between a defined benefit plan and a defind contribution plan and its implications. And that's around page 23 or 24 of the paper. I think that you have to separate this issue into two different categories. One is what I will call the legal standards and potential for violation of the law when investing in a way that sacrifices some risk for a reward, and the practical probabilities of loss to the beneficiaries. What I mean by that is, if you're in a defined benefit plan it does have certain guarantees under Title IV. A fair amount of the risk is absorbed by the corporate sponsor and the insurance system. But quite frankly, that does very little in terms of deciding whether there has in fact been a violation of prudence for holding the interest because you're on a lark somewhere. Although you may not have a direct dollar loss given the underpinnings of the insurance system, it still may be that the investment was imprudent. And you can enjoin that activity and you can require that it not be undertaken in the future. It's my experience that a number of senior trustees that invest money are as concerned with being sued and found in violation of the law and having injunctive relief assessed against them as they are about the money damages involved.

In addition, there's a real difference between engaging in an activity which is found in violation of the law for which damages are assessed and engaging in activity where there's an investment loss that occurred which you amortized over 15 years. We talked about this briefly at lunch. Experience gains and losses can be amortized over 15 years. If you are sued and you lose, the trustee or fiduciary involved will make a lump sum payment back into the trust not amortized over 15 years although loss occurred.

So there are a lot of distinctions in this process you have to deal with in determining where the risk falls, how severe it is, and what the remedies may be that can be assessed against the fiduciaries.

I have to take issue I guess with a point that Roy made about sponsors putting language in trust documents and other places such that they really don't stand behind the pension promise, they limit their liability to the trust instrument. I think in light of Title IV of ERISA, and in light of prior law dealing with contractual obligations that one assumes notwithstanding ERISA, that if the employer makes representations to employees about the kind of retirement benefit to be provided to them and then doesn't that language in trust agreements which says that the employer is only responsible up to the assets of the trust are much less comfort than most people realize, and most employers would indeed be liable to provide the benefit.

MR. SCHOTLAND:

Jim and I, I think, actually are in no disagreement about that disclaimer of liability. I had said I thought it was of

dubious validity and in fact would like it to go away and I would not read a great deal of comfort from it. But it is all over the place. I don't mean literally everywhere, but I mean in the majority of the situations and you can't yet establish clearly that it is invalid.

PART III
HEARINGS OF THE PRESIDENT'S COMMISSION ON PENSION POLICY*

**This section presents relevant portions of hearings held by Study Group III of the Commission on December 10 and 11, 1979. An effort has been made to avoid substantive duplication of the EBRI Policy Forum discussion contained in Part II. The full Commission transcripts are available from the Commission. The marked copy used to create this section is available for inspection at the Institute.*

The Legal Setting

THE LEGAL SETTING

MR. LEIBIG:

I think we are likely to agree that there are three basic rules that have to be taken into consideration. First, that legal advice should never be given that imprudent investments are likely to be legal or to stand up to a court challenge. Secondly, that any investment that is not cast in terms of the interests of the beneficiaries or participants in a plan is likely to raise serious questions. Third, that any investment that has any elments of self-dealing in it is likely to raise serious legal questions.

I think that in looking at these rules it should be kept in mind that at least in the last five years or so the likelihood that those rules give some recognition to socially motiviated investments is true, and it is not unfair to look at factual hypotheticals under the question of not whether socially responsible investments are permissible, but it also should be considered whether socially irresponsible investments may cause some legal questions in regard to the liability of those involved in making them.

I don't think that there is any area in the law where if you could establish a factual case that social irresponsibility, whatever that means, motivated an investment, that there wouldn't be a legal question of whether or not there is a possibility of an injunction or some other legal action to deal with it.

I think that the recent Department of Labor regulations and a number of Internal Revenue rulings indicate that there is nothing inappropriate to consideration of the social impact of investments.

MR. RIVIKOFF:

My name is Ronald Rivikoff, and with me is Myron Curzan. We are attorneys with the firm of Arnold & Porter.

As I am sure you are well aware, the prudent man rule in its traditional form provides that a fiduciary can base his investment decisions only on judgments as to the trust corpus and probable return on investment.

However, serious questions are now being raised whether this traditional rule provides sufficient flexibility, or rather should this rule be broadened to include a myriad of noneconomic concerns so that the fund resources can be employed in a manner to achieve other objectives? We believe that the current state of the law provides no clear answer.

In addition, as policymakers the Commission members are now confronted with two phenomena which we believe bear critically on this issue. First, you are, of course, aware of the increasing tendency of trust fund, notwithstanding this absence of guidelines, to advocate or adopt noneconomic criteria in their investment decisions.

Second, the current law on trust funds generally demonstrates a trend toward approving, to a limited extent, the use of noneconomic investment criteria. Therefore, we see a significant opportunity for the Commission to shape and direct this ongoing process. If the Commission supports the development of noneconomic investment criteria as we believe it should, then the task facing the Commission will be to develop a new prudent standard in which these varying factors can be evaluated by those who choose to apply noneconomic criteria to their investment policies.

We believe that the trend of the current law is moving toward a position which allows fiduciaries to consider noneconomic criteria. Therefore, new factors will have to be brought into account in determining the prudence of investment decisions which include such criteria.

Without attempting to be exhausting, we suggest that, in addition to traditional economic considerations, the following can appropriately treated as part of the prudence equation:

First, the degree to which the investment will provide other benefits to those covered by the trust plan.

Second, the extent to which the trustee is given guidance in the trust documents for such an investment.

And, third, the size of the investments that are based on noneconomic criteria as measured against the size of the overall fund.

In our judgment the key to an operable program, using additional factors outlined above, is trustee discretion. As in cases where traditional criteria alone are being applied, the trustee still must be able to justify and be held accountable for his investment decisions. However, it is this discretionary element which we believe also imposes certain limitations on the use of noneconomic criteria.

When, through the imposition of noneconomic criteria, a fiduciary is effectively restricted from placing funds into any significant range of normal investment vehicles, his ability to exercise his discretion and justify his investments is severely limited. Even under the most flexible prudent man rule, this type of restriction should clearly be subjected to the most piercing scrutiny.

Given this analysis, what, then, are our recommendations to the Commission?

First, we believe that this Commission should recognize the current trend of the law and investment practice, and find that investments can be prudently made using factors other than merely the traditional economic ones.

Second, the Commission should seize the opportunity to guide the focus this emerging trend through the adoption of a new prudence rule which would provide guidance for those who choose to use noneconomic criteria.

This new rule would recognize the availability of noneconomic criteria in making investment decisions. Further, if the trust creators and trustees opt to include noneconomic criteria, this new rule would provide guidance as to how these noneconomic criteria are to be evaluated by the investment managers. Above all, this new rule would provide for maximum trustee discretion.

Third, such an expanded rule should be applied to ERISA.

Fourth, we note the current focus in Congress on the regulation of public retirement systems. Alternatively, or as a supplement, the Commission should consider applying this new rule through some sort of uniform act to cover those plans not covered by ERISA.

These proposals are not, and should not be viewed as, a lessening of the prudence standard. Indeed, they require trustees to increase the attention they give to investment programs. This increased obligation to trustees is an option which we believe the participants and beneficiaries, as equitable owners of the trust fund, have a right to impose.

CHAIRMAN CARTER:

Thank you.

Mr. Feder?

MR. FEDER:

I serve as labor counsel to the National Coordinating Committee for Multi-Employer Plans. I represent collectively bargained plans. I represent multi-employer plans, and I represent people who sponsor them. To these people, the question

is not theoretical and, therefore, I am not concerned with the legal debate. I am concerned, however, to be sure that the legal debates center on the appropriate questions. Very frankly, I don't think they do.

The practical question that trustees are faced with is, can they sue pension fund assets in ways to benefit the membership of the union, most of whom are participants in the plan, and other workers, usually in the area of the plan? I think there are three general principles which color the judgment.

Number one, the fact that under ERISA apparently the prudence of an investment is measured against the entire portfolio rather than an investment by investment basis is vital.

Secondly, I think it is clear, and no one contests -- no one that I am aware of -- that investments must be designed both to preserve the corpus of the trust and to provide income.

Thirdly, it is clear that the trustee's duty is to the participants and the beneficiaries.

Those three principles impact on the decisions, obviously. The decisions I will focus on under so-called social investing are, in my judgment, not questions of social investing, whatever "social" means. I will talk about worker investments and worker oriented matters. I think there are three basic categories that we should deal with.

First is the affirmative investment of plan assets in economic activities which stimulate employment in the industry and geographic locale of the plan. I think that is a major, major concern of the trustees of collectively bargained plans and it is a principal questions that the Commission should focus on.

A second principal question relates to investments which result in benefits other than pension payments to participants as individuals, participants as a class, or to participants as part of a class which would be benefitted by the investment.

Finally, which is a negative element, I think the Commission has to focus on the decision not to invest in a particular venture so long as the decision reflects the interests and concerns of the participants of the class and not the short-term goals of the trustee or the investment manager.

Those are the three questions I think we are faced with.

The first question, on the affirmative investment of plan assets in economic activities which stimulate employment, is one that has been answered variably by people, but principally in the affirmative. The specific example that is easiest to deal with is a construction industry plan which seeks to invest in construction activity within the jurisdiction of the plan,

thereby generating jobs, and, one should not, thereby generating additional income to the fund. We should not ignore the generation of additional income to the fund. I plead to the fact that I am not an economist or an actuary, but it is my understanding that it is the additional income to the fund from employer contributions which enables most funds to remain in existence, not the earning of 3 or 4 percent which investment managers have been achieving over the past few years.

So the generation of additional employer contributions is vital to the continuation of the plan. Therefore, it seems to me, in the legal environment in which we are dealing, investment in such economic activities within the jurisdiction of the plan is equally vital and, therefore, a prudent investment and clearly within the exclusive benefit rule.

The second element deals with investments which result in benefits other than pension payments to participants as individuals or as a class or as part of a class. I will focus on two different examples, if I might. Can a pension plan provide mortgages to its members -- to its participants, rather -- at reduced rates? In my judgment it can, hypothetical. A pension plan which wishes to provide mortgages to its participants at 11 percent -- I think it can be easily documented in 1979 that despite what we hear about money market funds and everything else that is happening in the value of commercial paper, most pension funds are not realizing 6, 7 and 8 percent. So that a pension plan which wishes to invest in mortgages at 11 percent would be doing better than they are doing with most of their other investments.

It is clear that ERISA contemplates a plan being able to make loans to its participants so long as it is doing so on an equal basis, not discriminating among participants. I think, therefore, in terms of the current legal environment one can easily make the case, and ought to make the case, for a pension plan in these kinds of times to be making mortgages available to participants, whether they are retired or active employees.

Let me focus, also, on a piece of legislative history which I think is very, very relevant to this issue in ERISA, and that is that Congress recognized that there might be important values to be served beyond the participant universe. Indeed, the phrase used by the Congress in legislative history was "benefit to the community." In the statement of managers on ERISA, the Congress expressed its contemplation that a prohibitive transactions exemption would be granted in Dayton, Ohio, to permit corporate pension fund assets to be invested in downtown redeveloping, citing as one of the reasons for this being a good investment the fact that it would benefit the community. The specific case dealt with prohibitive transactions exemption. Clearly, however, Congress would not have been urging such a prohibitive transactions exemption if it thought that the investment was barred by the prudence rule.

The last item I will deal with is a decision not to invest in a particular equity, by way of example. It seems clear to me that a local building trades plan in Los Angeles is not obligated by ERISA to invest in a company which wholly owns a nonunion construction employer who is doing business nonunion in Los Angeles. That would be the construction example of the assets being invested in the competitor.

The other side of the coin, however, I think is much more important. I believe under ERISA the trustees are bound not to invest in that kind of a competitor, because that kind of a competitor is undercutting the possibility for future contributions to the plan.

In summary, I believe this is the legal environment within which we are operating. I think for the most part those things that are being contemplated as so-called social investments by plans are clearly permitted by ERISA. I would concur in Mr. Leibig's caution that they have to be carefully developed, all of the proper documents have to be prepared and implemented properly by trustees. But within that context, I think trustees have a great deal of flexibility.

COMMISSIONER DEAN:

I have a question for Mr. Rivikoff?

Do you agree with Jim Hutchinson's interpretation on the loyalty standard as acting in the best interests of the participants in their role as participants?

MR. RIVIKOFF:

Not entirely. I believe that the solely in the interest standard was an adoption of the duty of loyalty under common law and an attempt to recodify that in ERISA. I believe it was directed at the conflict of interest type of situation. I believe this is reflected in comments by Senator Javits when he first introduced portions of ERISA, and I think that Mr. Hutchinson might be reading that section a little bit too restrictively.

I feel that it really does not prohibit that type of situation where you are applying other types of criteria as long as you are not entering into a conflict situation.

In other words, that standard would apply regardless of the type of criteria you are using, the traditional economic ones or broadening the scope of your decisionmaking to include other types of criteria. The standard would be the same, and I don't believe that you would be getting into a prohibitive type of situation merely by the inclusion of noneconomic criteria.

COMMISSIONER DEAN:

Now, Jim, in his paper, talks a little bit about a benefit to participants as participants. What is your concept of the meaning of the word "participant" as used by Jim? Retirees as well as active workers?

MR. RIVIKOFF:

Well, the definition refers to current employees and retired employees, and I believe that ERISA looks to participants in both their active capacity and the retired capacity.

COMMISSIONER DEAN:

So both could be included?

MR. RIVIKOFF:

Yes, I believe so.

COMMISSIONER DEAN:

Very good.

COMMISSIONER GREENOUGH:

One comment, Mr. Chairman. Three times today the point has been made or the statement has been made that the yield earnings on persion funds in the last ten years have been 4 to 6 percent, and that, therefore, social investing at 10 percent, somewhat less, would be appropriate and legal and whatever you want.

I really have to comment on that with two points. One, that rate is the rate for the last ten years, including equities, and it takes from a previous high to the present level. Starting period, sensitive; end period, sensitive. All you need is quite a rise in stocks at the present time to make that 14 percent, or a fall to make it zero. But there is no relevance between that ten years ago and the present figure. In fact, ten years ago the price earnings ratio on the Dow was twenty-two times earnings. It is presently eight times earnings. So if the market was at the same level now -- which it shouldn't be; shouldn't have been back there -- as it was then, it would be over two thousand. So the statistic is just meaningless.

Secondly, it is a comparison of portfolio rate of an accumulating fund that has had to invest at various interest rates during a period of increase. So the statistic, although used three times to justify social investing, can't be so used.

The question a poor, nonlawyer in this coterie of experts would like to ask is, where do I go when actually investing funds, when you bring in social criteria? Now, believe me, I am not a Milton Friedmanite, although he was on my board when we

started discussing this. But when the Commerce Department and Juanita Crepps, when Harvard University, when the Russell Sage Foundation, and so on, can't figure out what social indicators really mean with respect to the economics or even the social factors on investing, how can the poor manager decide that and still stay within the present law or the laws that you are suggesting?

MR. RIVIKOFF:

I believe that what is socially responsible is a terribly subjective question. What I believe can and should be done is that participants and beneficiaries have a right to determine what other interests they want to serve and provide direction in the broadest sense to the investment managers.

But to simply say in a very limiting type of sense "This is socially responsible and this isn't," I don't believe is possible. Therefore, the most that can be hoped for is guidelines supplemented with broad trustee discretion.

CHAIRMAN CARTER:

Mr. Hutchinson, since you are one among the panel that seemed to take the most conservative posture on the issue of the introduction of some types of other than economic or financial considerations, I want to just see - I want to press you just a little bit to see if I fully understand, because people who are not disposed to do these matters obviously want to follow in your good advice and not be tempted by Mr. Leibig's assertion. So I want to see how far this -- would you say that those plans and investment managers, trustees and others who, for a long time, have been refusing to invest in liquor, gambling, tobacco, are they, in your judgment vulnerable under ERISA?

MR. HUTCHINSON:

I think that you are talking about retirement programs that are not invested in liquor or tobacco stocks.

I think there is some question as to whether they can rationalize that investment strategy as in the interests or the participants and beneficiaries of a particular fund. That is a very harsh, technical reaction. But I think there is some real question whether it can be justified.

However, I put it in the category in most cases, unless it is done to the extreme, of hurting the performance of the portfolio, because other alternatives are not available which will satisfy that plan's needs. It may be in the no-harm, no-risk category. In other words, to the extent there is little probability of damage, there is little probability of suit, and

therefore little probability of liability. However, that is a practical answer, and the first answer was a legal answer which, in my opinion, suggests that I think there is some question about that activity.

CHAIRMAN CARTER:

Well, going back to the no-harm, I get the impression -- I wouldn't want to misunderstnad you -- that you believe a portfolio is subject to being examined holding by holding, while there is some suggestion from the other panelists that the investment prudence would be measured against the whole portfolio, was one statement that was used, for example. The size of the noneconomic portion of the portfolio as against other investments, was another statement another panelist used.

How do you come out on that? Are we talking about how each investment performs, or are we talking about the particular investment? After all, whether you invest in liquor stocks or not might be a very small portion of your portfolio. It becomes important if you are going to be judged on that investment if it had a noneconomic rationale or not clearly be seen in the interests of the beneficiaries.

MR. HUTCHINSON:

If there is any misunderstanding about that, I am delighted with the opportunity to clarify it. I do not ascribe to any approach under ERISA suggesting that the standard requires an investment by investment defense of every particular holding in the portfolio. I believe that the whole portfolio approach that I describe in my paper suggests that at least the present interpretation of the federal rule is that you have to relate that particular investment to the entire portfolio, and that is a very relevant consideration, what the rest of the portfolio is doing and how it is structured.

What I hesitate to suggest is that some people say to adopt, quote, "the whole portfolio rule." If you find you made a good return and if nobody lost money, then that is the end of the question. I don't agree with that. What you have to do is you have to examine each investment, but determine its prudence in terms of how it adds to or relates to the entire portfolio.

I am not trying to be difficult in my distinctions, but --

CHAIRMAN CARTER:

Can you say a little more about that?

MR. HUTCHINSON:

Sure. Maybe an example would be helpful.

Let's assume that a portfolio is 95 percent in fixed income, blue chip type securities, which will produce a 9-1/2 percent return, and let's assume that 5 percent of the portfolio is essentially taken to Las Vegas and put on the gaming table hoping to hit a hundred to one. My suggestion is that the mere fact that the portfolio as a whole, because of the 95 percent of it that performed well, has overall done reasonably well even if the entire 5 percent is lost, is not the end of the inquiry. There is no mad money involved. There are no small pockets that can be used for whatever anyone chooses merely because the portfolio as a whole does well. That is my point. You still have to look at that 5 percent.

On the other hand, let's assume you took 90 percent in fixed income securities and decided that in the other 10 percent you were going to go into reasonably high risk ventures, but that had some possibility of return and were analyzed given the fact that there may be risk, but there is a potential for higher return, and that is what you are seeking. The fact that there is 90 percent in fixed incoem, which, even if 10 percent is lost, will produce an overall return, is relevant in considering how you invested that 10 percent.

MR. LEIBIG:

Let me add just one slight thing to that, which I think I probably first heard from Jim. The whole portfolio rule also does not apply to the self-dealing and the other tests. To the degree that they are self-dealing, even if you whole portfolio or even individual parts of your portfolio may technically do well, if there is elements of self-dealing or of nonconsideration of the interests of the participants on a single investment, there is going to be a problem.

MR. HUTCHINSON:

I fully concur in that.

COMMISSIONER GREENOUGH:

Calling on Lisle's question, is a noninvestment in gambling, liquor and tobacco in presonse to sensitivities to some group of participants the flip side of positive investment in unionized companies or local housing, or whatever?

MR. FEDER:

I don't know what the flip side is, but let me tell you --

COMMISSIONER GREENOUGH:

Well, one is positive making an investment; the others are negative not making --

MR. FEDER:

If we expand it for a moment and get a true flip side -- that is, an investment manager who has discretionary funds who refuses to invest in the construction of a hotel casino complex, who is the investment manager of funds of hotel and restaurant employees. That, I think, is the flip side, and I think he would be breaching his fiduciary responsibility for the participants in that trust if he refused because of his own judgments of morality not to invest in an institution which might gainfully employ them and provide future sources of contributions to that fund.

COMMISSIONER GREENOUGH:

Okay, that is the flip side. Is the other one, then, that if it would offend the sensitivities of a reasonable number of participants to be in those funds, it is okay not to.

MR. FEDER:

I think that is true.

Can I take that back to the question asked by Commissioner Dean, because I thought he had focused in his question on the definition of participant on a different question than the one that we went off on. Not whether participants are only retirees or whether it included actives, but whether you can only invest in the interests of participants as participants in the plan rather than in any of their other interests that they might have. I think really that that is basically the same question here.

I think the investor, the trustee, has to take into account the interests of the participants, but not just the participants' interests as a potential retiree or a current retiree.

If I can give an example of how we all, as prudent investors, do this everyday with our own funds, if I can go back to the common law definition. What do we do with our own money? Most of us, when we make judgments on where to bank, don't make that judgment solely on the basis of whether we can get 5 percent or 5-1/4 percent at a particular bank, or 6 percent in savings, or 10 percent in the money market fund. We think of other relationships we might have with those institutions and how else we might benefit from our relationship with that institution, not just whether we are going to get a greater rate of return on the particular pool of money we are putting into that institution.

I think the trustees can do the same thing with respect to the participants. Take the participant as a whole entity, a whole human being. What are the participants' interests, and take them into account.

CHAIRMAN CARTER:

Do you have something?

MR. HUTCHINSON:

I have to say that in many ways I agree with Mr. Feder's indication of what makes good policy, that you take a look at the entire person, if you will, in his capacity both as participant, potential retiree, worker, et cetera. But I am afraid I just don't find much help in the present law to suggest that someone with responsibility for investment decisions can do so. We are talking about what the law is and whether it ought to be different to take into account the needs and objectives of participants in a broader sense.

I have to say that I very much agree with the whole view approach, but I have a great deal of difficulty squaring it with what we presently have on the books today for the law, because the Congress, it seems to me, so far picked out a social need to be served by these monies and they indicated it would be retirement security. Now, that doesn't mean that they were right or it doesn't mean that it couldn't be different, but I really have a great deal of discomfort when I get too far away from that analysis of where the law is today, even though I agree with the intent that he is expressing.

CHAIRMAN CARTER:

Well, if that the test which you feel is primary -- and I don't hear anybody disagreeing with that as the primary test -- if, just as you have perceived an analysis of situations in which OSHA or EEO or other things of that nature might be involved, and that then puts it into your socially neutral, can you conceive of other, or do you recognize other among the current issues right now in soical investing? What about protection of the pension fund itself, for example, the argument that is advanced in relation to public employee funds, or it could even be private funds having to do with the economic growth and development of the area or the potential customers, or whatever else it might be? Could a rationale be constructed in the same way with respect to those issues?

MR. HUTCHINSON:

I believe that when you are talking about the preservation of the contribution base, I think is what you are really driving at, --

CHAIRMAN CARTER:

Right.

MR. HUTCHINSON:

-- you are talking about a parellel of the New York City situation. The Withers case, that was brought up in other testimony today, was a situation I think where the trustees focused heavily on the fact that the viability of the funds in many ways was dependent upon the financial stability of the community, and without the infusion of capital that stability would be gone. That was a non-ERISA case. I think if that had been tested under the present standards applicable to private retirement plans, I have doubt whether it would have come out the same way.

One thing that I point to, again -- not because I agree with that result, but because it appears that the law is more restricted than we would hope -- if you take a look at that case, the trustees followed a very careful procedure in analyzing what it was they were doing, why they were doing it, all the considerations they took into account, and one extra careful step they took, I think on sound advice, was to get a waiver from the federal tax laws which required that the fund be operated in exclusive benefit of the participants, and they wouldn't make the investment without such a waiver. So they at least were concerned that their activity to benefit the sponsor in this case, the contributing employer, the municipality, could be viewed as beyond the permissible bounds of benefitting the participants more directly in their capacity as participants.

CHAIRMAN CARTER:

Go ahead.

MR. FEDER:

I just want to stress a point I made very quickly in my comments. I agree that it is important for the trustees to act carefully in doing it, but there is reflection of congressional judgment, that perhaps for the first time 1974 the benefit of an investment to the entire community could be taken into account. It is one of the five factors cited by the conference committee on ERISA as its rationale for suggesting that the Treasury Secretary and the Labor Secretary exempt the investment of a particular corporate pension fund in a project in Dayton. The fifth of the five criteria specified by the managers is the importance of the project to the entire community of Dayton, Ohio.

I am not suggesting that that is enought to justify a particular investment, and I will also acknowledge that there were peculiar circumstances in this particular case. But the point is that in the right case, that community factor was considered acceptable by Congress.

COMMISSIONER DEAN:

We are assuming all that and just saying that we have a union man voting on it. Do we have to cast it out? As I read your paper, maybe we do.

MR. HUTCHINSON:

Yes, we do, and I disagree with that result. But I am afraid that is the kind of law -- I think we are both arguing that the law as it stands today, whether it is appropriate or not. That is the way I prefaced my remarks. I think there are some prohibitions in the present law, particularly in the prohibited transaction rules, which are so broad-based that they don't make good sense, and I think --

COMMISSIONER DEAN:

So you think it is the exclusive benefit test which has to be changed?

MR. HUTCHINSON:

No. I think there are two things you need to do if you choose to permit a broader range of investments and to take in considerations that we have been talking about today. One is to remove the prohibited transaction impediments that would prevent those investments. Secondly, to make it clear that the solely in the interest test means more than direct delivery of benefits. I think those are the two things that need to be done.

CHAIRMAN CARTER:

Go ahead, Mr. Feder.

MR. FEDER:

I am afraid to let a point rest here which is so clearly incorrect.

(Laughter)

If I don't make any statement....

The question that was put to Jim was whether an investment, which under all ordinary measurements by a collectively bargained trust is a sound investment, would otherwise meet the prudent standard, is a violation of ERISA if it somehow indirectly benefits the union just because one of the trustees who made the decision was a union trustee. If Jim's answer was restricted to the possibility that there might have been a technical prohibted transaction for which an examption could be secured, I won't challenge it. But if it was intended to reflect on the fiduciary responsibility standards, I have to challenge it, and more importantly there is law -- we may not like it -- but there is law directly on point dealing with the trustee who wore two hats in New York, which is the Controller of the State of New York, who the New York Court of Appeals found could very readily make an investment as the Controller of the municipal trust money in

MAC funds. The Court of Appeals said this was all right. Put aside for a moment whether any investment manager would have said that is all right. As a matter of law the Court of Appeals in New York did not find that to be a breach of fiduciary responsibility, even though he wore two hats.

COMMISSIONER DEAN:

Let me put this question to the panel, particularly in view of your most recent comments: If you have a direction in the plan instruments that the trustee many -- not shall -- may invest a limited portion of the trust portfolio in socially sensitive investments -- here I incorporate by reference the Hutchinson definition -- which benefits plan participants as participants, can it be said that then the investment is permissible despite the fact that a union or employee interest may be indirectly furthered?

MR. HUTCHINSON:

I think that that kind of direction in a trust instrument is very helpful to the fiduciary making the investment, because it indicates that he is following the plan instructions, and the only plan insturctions that he is not permitted to follow are those which are in violation of law essentially.

I think we are confusing a point, and that is the mere fact that there may be some collateral benefit to third parties, that mere fact, as Jerry Feder stated, and I agree with him, does not necessarily make the investment in violation of law. There is a lot of law under the Internal Revenue Code and in the common law which indicates that third parties can get some collateral derivative benefit from an investment activity, but you have to show that the investment's primary purpose was to serve the participants and beneficiaries.

Wholly apart from that, there can be situations where the primary interest of participants and beneficiaries is taken into account, where the investment is prudent, and, as Jerry said, in a very narrow, technical sense there could be a structural prohibited transaction just because of the relationship of the parties. It is some of those rules that people can unwittingly trip over. I am not suggesting that I support the rationale of those rules. I am just describing them.

COMMISSIONER DEAN:

So even if you put in primary benefit to the plan beneficiaries, you would still run afoul of the prohibited transactions?

MR. HUTCHINSON:

You could. They are two separate questions.

MR. WOODRUFF:

I just have one question because I guess I am a little confused at exactly what the response is. This has to do with the -- in Jerry Feder's opening remarks about the affirmative obligation in the case of your Los Angeles construction firm or holding company of nonunion Los Angeles operation.

You said that there would be an affirmative obligation on the part of the trustees to not invest in that firm. Do the others on the panel agree with that interpretation?

MR. HUTCHINSON:

I don't find anything in the law which leads me to that conclusion.

MR. LEIBIG:

I think that I do agree with the conclusion. I think, and I am not sure of the hypothetical -- you would have to have a very careful hypothetical -- but I think that a very strong lawsuit could be framed if such an investment were going to be made that would be the basis for asking that the investment be enjoined. I think the case would be very strong.

I have to say, and I think Jerry would agree, that one of the irritating things about this area is I haven't been able to find any case where that was done. I must also say I haven't been able to find any case where the opposite was the case, others than _Withers_ and _Blankenship_. There is no cases where someone wanted to do it and was prevented from doing it, making a socially responsible investment, or a case where they were making what I would call a socially irresponsible investment and someone got an injunction.

But the law is very clear that a case could be made and papers could be filed that would be far from laughable -- in fact, pretty strong -- arguing for an injunction to prevent what Jerry was talking about. I think there are a lot of people...

MR. FEDER:

I don't have the benefit of a case to cite; if that is the question.

CHAIRMAN CARTER:

Mr. Rivikoff?

MR. RIVIKOFF:

Well, I agree, I don't know of any proscription on a fiduciary that requires an affirmative duty to invest in a certain way. But I believe that it would be appropriate for instructions

to be given to the trustee to take these type of considerations into account. But absent these, I don't believe there is any affirmative duty.

MR. WOODRUFF:

If the situation were changed somewhat so that maybe all of your participants were in Los Angeles, but the firm currently wasn't in Los Angeles, but, say, was in San Francisco, or something, then I presume your belief in the affirmative obligation would go away, wouldn't it? Is it the threat to the contribution base of the fund that you are saying, as far as the affirmative obligation, or is it the fact that they are anti-union or nonunion?

MR. FEDER:

The answer is it wouldn't necessarily go away. A lot as a matter of law would depend on the facts. For example, if there were reciprocity agreements between the Los Angeles and San Francisco people.

The case can be structured where the fact that the company in which the investment might be made is somewhere else would not necessarily be relevant.

To deal with your question, however, I assume it is can you, or is there an affirmative duty only to invest in union activities? I have not been able to find that affirmative duty in ERISA or in the common law. By the same token, the issue has never been that. The issue has always been is there a prohibition against investing that way, and I think the answer to that is no.

CHAIRMAN CARTER:

We would like to give you a moment to say anything in conclusion you might want to say.

We will start with you, Mr. Rivikoff.

MR. RIVIKOFF:

I believe that there is just no guidance at all in the law in this area. Various people take various positions on what can and cannot be done under the existing law, and I believe there is a crying need for some sort of guidelines. Despite the fact that a number of people advocate the position that, "Yes, we can take certain steps," in fact a lot of investment managers are taking the opposite position, and I feel for the active investmen manager guidelines are needed to permit this type of activity and clarify his role.

CHAIRMAN CARTER:

Mr. Feder.

MR. FEDER:

I would only conclude that although there is not a plethora of decisions throughout the entire area, the ability of trustees to invest with the goals and objectives that we have described today in mind is a lot clearer than most people suggest and they don't have the impediments that are presumed to be there, at least as described to trustees by investment managers and others who have particular interests in doing it a particular way. Trustees have a lot more discretion than most people think they do today.

MR. HUTCHINSON:

As I said at the outset, if the Commission's conclusion is that this sort of activity ought to be fostered, enhanced, encouraged, whether my restrictive interpretation of the law will win out or not, I think that giving people some comfort either by way of legislation or otherwise is going to be necessary.

MR. LEIBIG:

I would like to make two points. One is that a lot of what we have discussed has not focused very much on the state and local situation when, in fact, the pressure for social investing is much more concentrated in that area than in the areas we spend some of our talking on.

Secondly, I would like to say that I strongly disagree with two of the summaries. One is, I don't agree that there isn't a great deal of legal guidance here generally. The reason I say that is that I am concerned with the suggestion that the only way to solve this social investing issue is an amendment to the fiduciary standards in ERISA. I am primarily uneasy about that because, one, I don't think that is going to happen, I don't think it is possibe; secondly, I would be very uncomfortable with an idea that we would pass a, quote, new fiduciary standard at the federal level in 1974 and then in 1980 change it to another new one, and I think the danger would be that we might, in 1984, change it to another new one. One of the values of these standards, I really think -- although I am in favor of social investing and think it should be done -- is that you do need some stability of the law that you make reference to. I think if we are talking about the law developing, we are talking about the kind of cases that Tom mentioned being broad, and I don't think it is a good idea to be shifting the ground rules or the guidelines too readily to deal with the problems. It is better to let the law develop.

The Participants' Role in Setting Investment Policy

THE PARTICIPANTS' ROLE IN SETTING INVESTMENT POLICY

COMMISSIONER DEAN:

I heard you last Thursday and enjoyed it very much, but could you give me a few for-instances on investments where the reasonably foreseeable consequence is to undercut the participants' interests?

MS. FERGUSON:

Law professors always ask hypotheticals of former law students, and I always have trouble responding. Let me give you an exaggerated one.

If you had a pension fund of a company in an area where J.P. Stevens was competing, let's say. It is a textile company and J. P. Stevens was a competitor, and that money was their pension money. The first company's pension fund money was being invested in J.P. Stevens. I think an argument can be made that the effect of that would be to give J.P. Stevens a competitive edge. This could conceivably mean that the first company might ultimately have to shut down if the competition were too good. If it were shut down that would mean that the individuals without vested pensions would have nothing. You would then have other people with frozen pensions and other people with partially insured pensions, and so forth.

COMMISSIONER DEAN:

So you are saying a union company and a nonunion company operating in the same area.

MS. FERGUSON:

I am saying that is the easiest example, yes, where you have direct competitors. Our problem and the participants' problem in the position that I presented last week and today is that we have a tremendous burden of proof; I mean, overwhelming.

COMMISSIONER DEAN:

Do you refine that to all unions or just --

MS. FERGUSON:

No, I would not.

COMMISSIONER DEAN:

-- to a union company whose union members are covered by the plan which is making the investment in question?

MS. FERGUSON:

I would require a direct nexus between these participants. I would not have a categorical nonunion thin, cause I don't think ERISA supports it. I mean, personally I would like that, but I don't think ERISA would support that. I think you have to have adirect tie to the retirement income security of these participants.

COMMISSIONER DEAN:

This question may more properly be asked this afternoon, but I have had some difficulty with one of the things I heard on Thursday, that an investment might properly be made where it is demonstrable that it will benefit participants as participants. Now, what does that mean, "participants as participants"? Does that mean active workers, does it mean retirees, does it mean both?

MS. FERGUSON:

I think it has to mean both. I mean, I don't think you can -- or at least I think you have to make sure that it won't hurt one group. If you are going to benefit the actives, you have to make sure you are not going to hurt the retirees, and you have to make sure that it is as good as any investment that you can make in the interests of both groups, and both groups have to be considered separately.

COMMISSIONER DEAN:

I am inclined to agree with you, but my colleague Roy Schotland shook his head no.

MR. SCHOTLAN:

I get a little troubled as soon as we talk about benefitting one group and just making sure we don't hurt the other.

COMMISSIONER DEAN:

Karen said that she felt that --

MS. FERGUSON:

Both groups should be benefitted.

COMMISSIONER DEAN:

-- as I understood her to answer, that both --

MR. SCHOTLAND:

I understand, but I think that we have to try to benefit them as equally as we can, rather than benefit here and no injury here.

MS. FERGUSON:

I think I would certainly prefer Roy's posture, but I think that in the real world you might find situations in which the investment was to the advantage of one group, not to the disadvantage of the other, and there might be a general feeling of "why not?" Now, if you are then faced with an alternative investment where it benefits both groups, that is obviously the preferable investment.

CHARIMAN CARTER:

In your judgment or, rather, based on any information that you might have, what participation makes any difference or would make a difference?

MS. FERGUSON:

Well, I think you only have to look at major corporations where the issue is presented very clearly. In some instances a few stockholders can make a very substantial difference in particular issues. I would like to see the greatest possible participation bcause the odds are better then that you will have full input.

MR. BARBER:

I would say in terms of direct observation, the real question behind what level of participation is going to make any difference is what level of support do those who are participating have in terms of backup from experts and various professionals, what kinds of information they have available to them, et cetra.

Clearly -- for instance, just to take a side example, UAW recently bargained an agreement which puts one of their members, their president, on the board of Chrysler. Clearly Doug Frazier is not going to be able to outvote the 17 other trustees on that board, but he will have access to information they have not had access to before. Clearly in a watchdog role, one person is probably as good as a few more if they are in a minority.

Beyond that, I would say that an effective level of participation is one in which you can have an actual impact, and I would suggest that one way or another that means either 50 percent or some kind of well-defined criteria through which minorities can have their particular perspective hold if they have covered other points.

MR. STRAW:

We are not supporting anything that would suggest tokenism or just put someone on the board and he is outnumbered twenty to one without any particular support. Again, I come back to this concept of effective control in which you have the ability and the information to make changes. In some companies that could mean representation by two or three. In other companies it may require more.

But, again, Mr. Chairman, to use Germany, and I am not suggesting that it will work here, many labor people suggested it may not work here, but this concept of 50 percent of the board members being workers and 50 percent being management might have some appeal.

CHAIRMAN CARTER:

I think we had better sum up so you will have a chance to make comments.

Why don't we start with you, Mr. Straw. Is there anything more you want to say?

MR. STRAW:

All I want to say simply is that as a union we support the concept of participation, period.

MR. BARBER:

Just very briefly I would like to say that Mr. Greenough suggested that there are some institutions for which the political process is not necessarily the best way that decisions should be made and that those institutions should be governed, and I would agree with him. But I would suggest that there is a test that probably should apply to determining whether or not that institution should have the political process, the democratic political process, apply. I would suggest that that test is the level of impact that that particular institution has on the participants, the members of that institution, and frankly on the broader society. I would tell you that I believe that by any measure the continued growth of pension fund assets, their investment and their allocation have such a major impact upon the economic life of our society and on the economic security of their participants that it is one of those institutions which should have thoroughly imbedded in it a rational, political and democratic process.

CHAIRMAN CARTER:

Ms. Ferguson?

MS. FERGUSON:

I think I would like to say that I -- different from Ronnie and Randy -- I would be very disappointed if you did not come up with very specific recommendations as to how best to inject participants into the investment process. Congress is looking to you for specific recommendations. Congress can only act on specific recommendations.

MS. METZENBAUM:

The question I want to talk about today is: Should non-management participants play a role in establishing investment policy? I think the answer to that question is yes, for three reasons.

First, employees should participate because they are partial owners of pension funds and, as such, ought to have some say in how the money is invested. In our society people have a right to dispose over resources that belong to them, within the limits of the law, of course. Employees have a right to use their wages as they see fit, shareholders have right to participate in corporate governance because they are owners of a company, and, similarly, pension participants should be able to participate in deciding how their pension fund assets are allocated.

I am not arguing that pension funds belong exclusively to the employees. Employers who bear a risk of investment loss -- most notably those who offer defined benefit plans -- can also be considered partial owners of the fund. But they are by no means the only owners and, therefore, should not have sole control over investment decisions. Employees should also participate in those decisions, if only to help choose investment managers and set investment guidelines.

There are two additional reasons why I think employees should participate and public representatives should participate in the investment process.

One is that pensions have historically been susceptible both to abuse and to stagnation. By abuse, I refer to the problem of trustee use of pension funds for personal gain or the gain of friends; and by stagnation, unacceptably low returns that often result not from malice, but from laziness, indifference, or unquestioning adherence to standard operating procedures. Involving nonmanagement participants will not necessarily eliminate these problems, but opening up the process to increased public scrutiny ought to provide some check on the system.

The other is that employees and public representatives may introduce factors not currently taken into consideration into the calculation of return on investment. Generally speaking, investors take into account several factors: the expected dollar return on investment, the administrative difficulty of making an investment, and the cost of learning about it.

Employees might introduce other factors into the investment calculation, such as the number of local jobs that an investment is likely to protect or generate. This internalizes real potential costs and benefits usually omitted from calculations of return on investment.

The Targeting of Pension Capital

THE TARGETING OF PENSION CAPITAL

MR. O'BRIEN:

I am here this morning on behalf of the ERISA Regulations Industry Committee to comment on social investing of pension funds.

First, I would point out that the primary objective of pension plan funding and asset investment is to insure that workers will have secure income after retirement. It should be noted that the achievement of this objective, which in and of itself constitutes socially responsible behavior, should not be compromised or diluted by the introduction of secondary objectives requiring the application of plan assets to promote other interests.

Further, ERISA clearly specifies the responsibilities of plan fiduciaries. They are to invest the plan assets solely in the interests of participants and beneficiaries and for the exclusive purpose of providing benefits. Accordingly, pension plan fiduciaries must act in the interest of participants as future retirees and not as active members of the U.S. work force.

In this latter context, the differences in economic interests between the active participant as a current worker and as a future recipient of pension benefits must be recognized. The primary source upon which the retiree population depends to enable it to continue to share in society's economic growth is the pool of pension fund capital with two attributes: adequate accumulation of assets during the working years of future beneficiaries, and optimum productivity of those assets in terms of their investment yields or returns. The interests of retirees can only be prejudiced to the extent that pension capital is invested to meet the current economic and social interests of active participants, to the extent that this investment bears increased risk and lower returns.

One other basic tenet of those who would impost participant involvement in the setting of investment policy is that the pension assets belong to the workers. In the case of the defined benefit plan, this is clearly a weak argument. The employer has agreed to provide a certain pension. He makes the annual contributions to the funds based upon an actuarial determination of payments to current retirees and an amortization of expected payments to future beneficiaries. To the extent

that the amount set aside for the future -- the pension capital -- proves inadequate, the economic impact is on the employer. He must pay the difference. Moreover, to the extent the pension capital is not maximizing earnings, the need to make up the shortfall could put a marked strain on the financial well-being of the employer.

In turn, this would be to the detriment of participants in the pension plan since the employer's ability to provide pension improvements, or even to continue contributions to the existing plan, might be jeopardized.

With respect to the defined contribution type of plans the assertion of the participants' ownership of the assets may have more validity since the employee benefits are derived directly from plan investments. Thus, it is the employee and not the company who directly bears the brunt of lower investment returns which might result from investment in, quote, "socially useful projects."

Here again, however, it is imperative to appreciate the paramount interests of participants as present and future retirees. By introducing social investment criteria which may cause a shortfall in the accumulated capital, participants work against themselves. They give up something in the future for perceived benefits in the present.

Stated another way, if pension capital is impaired because of investment policies meant to serve the interests and objectives of participants while in the active work force, this can only reduce the assurance that the promised level of benefits will be paid in the future.

To insure the payment of future benefits to retirees, it is essential that plan assets be invested to seek the highest return commensurate with a reasonable level of risk, including sufficient diversification of assets to adequately protect principal.

MR. ALLEN:

I am here representing the Association of Private Pension and Welfare Plans. Overall we feel that fiduciary standards do exist in the law at this time and they appear to us to be quite adequate. We also subscribe to the concept that we are investing in an efficient market and that investments that are attractive from the viewpoint of risk, from the viewpoint of yield, will attract investors, be they pension funds or other investors. To the extent investments are mandated, or to the extent that they are prohibited, and to the extent that this carries with it a cost, either in terms of a lower yield or in terms of a higher degree of risk, there is in fact a subsidy, there is in fact a cost. One question we would like to pose to the Commission, because we

think it is an important one, is it right that any such cost be absorbed by only a part of the population, the part consisting of those employers who have established private plans, and those employees who are participants? Because if we are dealing with socially desirable investments and concepts, this is a matter of general interest to the general public and might well be supported by a broader approach to the use of general revenue.

Another comment we would like to make is that if we are going to consider making any major changes in investment standards or requirements, that this be made in terms of a very hard appraisal of the reality of the situation. Just in fact how many serious problems have we had with the current system? How difficult has it been living with the current fiduciary standards in the market system that we have? Are we dealing with practical problems or potential ethereal problems?

Another comment that we would care to make involves the fact that in considering this whole area of investments we are dealing with the asset side of the pension balance sheet. We think some very clear attention ought to be given to the fact that there is a liability side. Once assets are in a pension fund, or a profit-sharing fund, whatever it may be, clearly the fiduciary standards require that they be invested solely in the interests of participants and the beneficiaries, and with a high degree of prudence and so forth.

However, to the extent that we have a defined benefit pension plan, the employer has made a commitment, he has accepted the commitment to produce a level of benefit at some time in the future, and he has accepted the cost of funding that particular benefit. If any restrictions are imposed on the ability of the fund to invest and if, in fact, there is a reduction in potential yield or a higher degree of risk, that employer in the short term is faced with making up the shortfall of the investment situation. If an employer, therefore, is looking at the situation and if these restrictions are imposed, it is possible that many employers might reduce the type of commitment they are willing to make to employees. If an employer is willing to commit X dollars to a pension scheme and if, on the basis of certain predictions as to yield, this will produce wide benefit, a situation where the yield is reduced or potentially reduced might very well cause that employer to reduce the commitment to something like 90 or 95 percent of Y. Or, I think more importantly, some employers, particularly the smaller ones that have not yet adopted plans, might very well decide to change the nature of the commitment and transfer the investment risk directly to the employees in the form of some kind.

MR. SCHWEKE:

While economically depressed areas of our country desperately need new capital to attack pressing social and economic problems, less and less will be available in the coming years. Indeed,

at all levels of government, the new austerity psychology is forcing policymakers to reevaluate social programs and priorities.

With public spending for job creation, neighborhood revitalization, and economic development less available than in past decades, the primary victims will again be the poor, low and moderate income people, and politically powerless minorities.

In the recent past development efforts in economically disadvantaged regions have been funded by tax monies accrued through rapid economic development in other regions. This traditional strategy, barely adequate in previous decades, is totally inadequate in the seventies, with OPEC price increases, continuing economic stagflation, and the growth of widespread political pressure for budget cutbacks of public spending.

New approaches and new sources of funds are thus required to meet the challenge of the eighties.

America, after all, has enormous capital resources. Concentrated in commercial banks, savings and loan associations, credit unions, life insurance companies, government accounts, and private and public pension funds are most of the capital resources needed to attach America's social and economic problems.

While considerable attention should be focused on new ways of involving the private sector, even greater attention must be focused on those capital resources that are managed by public agencies or are amenable to public influence. In this category, public employee pension funds comprise one of the largest sources of capital with over $130 billion in assets. This enormous reservoir of capital must, of course, be managed for the benefit of public employees. But these pension funds could also be transformed into community and economic development funds that are able to meet some of the unmet credit needs of our society.

Yet, if these new objectives are to be realized and pension fund capital is to be invested on the basis of public need, a long process of program development, research, and analysis must begin, and effective new financial instruments and investment options must be designed if the capital of public retirement funds is to be used safely and successfully.

Until recently those technical experts who have been involved in development finance issues have been involved in dealing with the problem of redlining of commercial banks, creating new public venture capital firms like the Massachusetts Community Development Finance Corporation, et cetera, have not focused on the problems and opportunities offered by public employee pension funds. This situation is now changing with a whole number of different studies that are being conducted by the Conference, as well as a number of other organizations. Already a number of

good portfolio analyses of particular pension funds have been performed, good preliminary work has been done on the whole concept of socially responsible investment or target investments, the role of the multiplier, some of the legal issues, et cetra, et cetera.

However, none of these studies have really looked at the issue of alternative pension fund investments from a development finance perspective. Such a perspective adds a critical component. Most current advocacy analysis on pension fund investment strategy simply points to general socially-useful sectors such as housing, energy conservation, et cetera, while need additional capital. Development finance consciously attempts to direct captial to certain specific sectors which traditional capital markets do not serve, such as distressed areas, small business, or minority enterprises. These traditional capital markets fail to meet these capital needs despite the financial soundness of the investments and/or the considerable accompanying social benefits.

Furthermore, many of the claims for the role of public and private pension funds in financing a new economy were overblown, oversold and undermonstrated. Instead, what is needed is a coherent documentation of capital needs/capital gaps and a careful determination of what financing needs and policy objectives can the investments of public employee pension funds most efficiently serve. In fact, there has never been a decent study of how the match can be made between these new investment possibilities with the capital structure of public retirement funds.

Secondly, despite a growing literature on the issue of alternative pension fund investments, a comprehensive picture of the legal, organizational, financial and political obstacles facing pension advocate has not yet emerged. The discussions have been too sketchy and cursory, and have not systematically dealt with the formidable obstacles that up to now have prevented public pension funds from participating in development finance. In fact, none of the studies have devised, on the basis of such an analysis, concrete mechanisms, institutions, political strategies, and reforms for eliminating or weakening these constraints.

Pension funds can play a particular role, and a specific and very limited role, in development finance, alongside of regional development banks or other sorts of institutions, or certain changes in private sector activity in terms of the loans of savings and loans and commercial banks.

MR. LaFLEUR:

The Wisconsin Retiremen Runds have approximately $4 billion in retirement funds. The funds are invested in a broad range of debt and equity type instruments.

"The Investment Board is very cognizant of the actual or perceived socioeconomic consequences of its investment decisions. The touch-tone for investment action is that such action must enhance the post-retirement financial security of the 280,000 participants, annuitants, or other beneficiaries of the funds under management. This objective does not conflict with our desire to maintain investments only in those corporations which consistently adhere to high ethical and moral standards in their business practices. In other words, the Board believes that companies which are the best citizens prove to be the most financially rewarding over the long term. Therefore, we avoid socially deleterious investments out of enlightened economic self-interest."

In other words, we think this issue is somewhat overdrawn, the inherent conflict between social investments and so-called financial investments.

"Wisconsin-based corporations or those with operation within the state are not favored or disfavored relative to our universe of investment opportunities. Nevertheless we are very receptive to and encourage as many contacts and financing proposals from Wisconsin companies as possible, with the clear understanding that our risk and rate of return standards will be applied as rigorously as elsewhere.

"The Board is aware of the appealing notion that perhaps a disproportionate share of the monies available to us should be targeted for Wisconsin-based businesses with the hope of enhancing the economic welfare of the state. However, close examination of the actual flow of capital funds within the United States reveals that investment capital moves quite freely across state borders in search of the optimal risk reward opportunities.

"Unilateral attempts to thwart this process have usually proven futile, but history also indicates that the specious idea of keeping the money at home will continue to be resurrected, most recently under the title social investing.

"The Board remains committed to a policy of reliance on the discipline of the market as the price-setting mechanism for its investment decisions.

"The trustees and staff are dedicated to acting in a manner which confers equal benefit to all covered Wisconsin public employees regardless of age, sex, salary classification, union affiliation, seniority, or occupation. In so doing, the Board does not endorse investment proposals which appear aimed at affecting special political, social, and economic advantage or leverage to subgrounds within or external to the benefificiary group.:

The concept of reasonable investing, as we have seen it in Wisconsin, is actually a very old idea. It is not by any means a new idea, and I will quote a former chairman of the Council of Economic Advisors who said very recently that -- this is his line, but it is applicable to the notion of social investing:

"It reminds me of an old power lawn mower I once had. It sounded terrific on the asphalt, but once it hit the grass it wouldn't cut."

Unfortunately, and characteristics of much of the analytical work that has been done on this by public interest groups, most of the work tends to be abstract concepts and political value judgments, and conspicuously absent are what I would call real world economics, the financial needs of the participants, beneficiaries, and concrete definitions and guidelines to implement any of the policies that are advocated.

My most serious reservations about this whole concept is that while I would concede that the markets are not perfect, the objective here is to move in the direction of perfect capital markets, and we are doing that. We should be breaking down barriers rather than increasing barriers. You increase a barrier where you arbitrarily state that capital should go to a certain point.

We are not really persuaded at this time that we would be successful in targeting, in keeping dollars in Wisconsin and be able to measure those results. The reason is because of this efficiency. We think that a consequence of deliberately overcommitting funds to a given type of investment or geographical area must necessarily involve increased risks or decreased reward; that is, some kind of a concession.

To ignore the price and yield signals of a competitive marketplace is akin to driving an automobile through a red traffic light.

This is another, and this runs to what Mr. Love was saying earlier. If you introduce other criteria, if the direct measurable, monetary yields of investments are ignored or relegated in favor of noneconomic criteria, the results are likely to be inequitable and inefficient deployment of capital in the conversion of public retirement funds into politicized income redistribution mechanisms. I think that is a very real concern.

MR. BARBER:

The Council of State Planning Agencies is an affiliate of the National Governors Association. We strongly believe that the overriding responsibility of anybody who wants to talk about investing pension assets is to protect and, where possible, increase the value of those funds for their ultimate beneficiaries, public employees.

I don't think, however, that for the most part the debate that has gone on on both sides of the issue has been very sophisticated. I would like to, by describing this project, try and distinguish between those changes in current investment practices which, however desirable they might be in some social or moral sense, have the effect of potentially jeopardizing the character of the fund as the beneficial trust, and those others which would lend a greater dimensionality to the investment process, not as a substitute for basic standards of fiduciary responsibility, but as a reflection of some greater sophistication about how those standards could be preserved.

Given the deplorable performance of most pension portfolios over the past decade, leading some people to talk increasingly about a purely random selection of investments, a greater sophistication is not in itself a very difficult thing to argue for.

Unfortunately -- and as Jim points out in his testimony quite well -- much of the debate over how these funds have been invested, I think it is fair to say on both sides of the issue, has been characterized by bad economics and unthinking reliance on outdated interpretations of the prudent man rule and to grossly exaggerated claims for the power of capital loan to spur development.

I would like to describe now this project that we are beginning with our states, because I think the findings of it will be particularly relevant to the Commission insofar as they suggest a way in which pension investments could be made socially responsible, economically productive, and fiduciarily sound.

We are beginning with a detailed examination of the present investment practices of each state's pension fund, reviewing the legal basis for pension investment, the relevant statutes, the defined benefit and contribution levels, the composition of the various governing boards. We will then analyze current actuarial assumptions, funding levels, and management practices, and take a detailed look at the composition of financial instruments, their maturity, sector, rating georgraphic location, yield, risk, liquidity, and transaction costs. Once we do this, we will turn to an identification of additional investment opportunities for each fund.

Once this process is complete, we will try to look at how we can take these new opportunities and transform them into suitable pension investments, and here the process grows somewhat more complicated.

In the final phase we will be using a regional input/output model to estimate the state-by-state change in income and employment resulting from given levels of net in-region investment after an adjustment for the capital displacement effects.

I have gone into all this detail only to make clear the very many technical problems that I think are associated with the development of new investment opportunities for pension funds, but I think any approach to using pension funds for regional economic development purposes must proceed along lines that are similar to these, at least similarly complicated and sophisticated in an economic and financial sense.

Last week I attended the Employee Benefit Research Institute's seminars on this issue and I came away thinking that it is just altogether time that both advocates and opponents of alternative investment strategies stop sniping at each other. They took some of the energy that is now wasted on rhetoric and vitriol and put it to work looking at how our financial markets are operating and how some underfunded enterprises could be transformed into acceptable pension investments. I think we can begin to make these investments in a way that is more financially sophisticated and economically productive.

MR. MARCUS:

Some months ago, in preparing a series of articles on the future of pension funds and retirement security, based on the fact that total U.S. pension fund assets were rapidly approaching a trillion dollars, I asked a particularly successful investment manager to comment on the impact of this growth. His response was that as soon as the government got wind of it, they would find some way to get it. And not just the government.

This vast and growing pool of money glitters and glows, and with the knowledge of all the good it can accomplish -- and all the bad, as well, I realize -- it gleams as a potential solution to the ills of civilization. It can save cities from bankruptcy, as it did New York. It can be fed into the capital markets to serve the needs of capital-starved smaller businesses and emerging companies. It can be used to solve the debilitating and degrading problems of regional underdevelopment. It can be invested within one state or region to help local business compete successfully against businesses from other parts of the country and thereby save jobs. It can be used punitively by depriving those corporations with perceived anti-social behavior of it, in the form of invested capital. Certainly it must stick in the craw of any union fund to buy stock in any company with anti-union policies.

All that money and all that power that money in this quantity buys can be used as a tremendous force for social good and as a powerful weapon against social evil.

Germane to the subject of investment of pension assets is the concept of prudence under ERISA, a subject I explore in minute detail in my book, The Prudent Man - Making Decisions Under ERISA. In that book, written with the intensive aid of

eight of the most cogent experts that could be found -- some of whom have testified here -- and the editors of Pensions and Investments, both the law and its intent were explored. The conclusions were ultimately sustained by the Department of Labor. They seem to me to be quite clear.

Briefly, it is clear that the intent of the law that the primary concern in all actions shall be the welfare of the beneficiaries. The money in the fund belongs to the beneficiaries, not to the corporation or any other organization that made the contribution to the fund. Each fund must be seen as unique, and all investment judgments must be made in that light. Fund objectives and, therefore, investment objectives must be made in that context. All investment vehicles consistent with the written objectives of the plan are likely to be purdent. And significantly the portfolio -- the balance of investments in terms of risk-return potential -- and not the individual investment, is the basis for judging prudence.

Clearly, this does not preclude high risk investment in venture capital or even so-called social investment if the investment potential if consistent with the needs and the objectives of the individual fund. Furthermore, given a choice of two investments of equal risk-return potential, there is no stricture against opting for the one that serves a social or a regional economic need.

But these are the clear limits of prudence in terms of using the pension fund assets in any supernumerary purpose, socially beneficial or not.

Now, I might reaffirm here that pension fund investment, as other speakers have noted, suffers both from a failure of words to understand the difference between the traditional prudent man rule and the ways in which it is modified under ERISA, as well as from the astigmatism in the extraordinarily lack of sophistication in investment pracitice by many pension fund and investment managers.

Now, I am keenly aware of the need to solve the acute problem of channeling capital to emerging companies and to assist in regional economic development, and I have published widely in this. I understand the reasoning behind economic support of regional job-producing industry, as well as economic sanctions against companies that seem incapable of understanding the human factor in society and economic life. But I also, realize that under the present law and under our present economic system the primary consideration in investing pension fund assets -- legal, social, and otherwise -- is the beneficiary, and must remain the beneficiary.

Nor is changing the law the answer. To mandate social or economic benefit, in view of the structure of our capital markets, is to jeopardize and ultimately subvert the rights of

the beneficiaries. That submarine may be redesigned to fly, but it would then be a mediocre submarine and an unsafe aircraft.

Is there no way, then, to use pension fund assets -- that vast, glittering pile of money -- to a broader economic and social benefit? Possibly. There are, conceivably, investment vehicles that can be designed to bring higher risk investments into a more adequate risk-return pattern for pension fund assets. While no such vehicle has as yet been perfected, some kinds of funds and some kinds of government guarantees are worth considering.

But at the same time, it should be recognized that, for example, the capital problems of small business are not primarily a problem of cash. They are a problem of the mechanics of the capital markets themselves. The problems of money for regional economic development are not problems of cash. They are problems of mechanics and vision, the mechanics to determine the best ways to channel money to where it can do the most good; to determine, in the first place, what is the most good.

To think of using the stock market as an economic sanction against a company whose policies are anathema to a group is to fail to understand the nature of the stock market. Need anybody with any knowledge of the market be told that when you buy stock in a company you are merely recycling that stock for your own benefit? The company already has the money from the original sale of the stock. True, liquidity is an aid to selling that original issue, but let's not inflate the contribution it makes to the company, nor the detriment to it of economic sanction in the stock market.

There are real problems to be solved in our society and our economy. There are potential solutions, some of which may even lie in devising new vehicles to channel pension fund assets into the capital markets without jeopardizing the rights of the beneficiaries. But let's not fool ourselves into thinking that because the money in pension fund exists, it can in any way be used to serve an extraordinary purpose without grossly subverting its primary purpose, to serve the needs of the beneficiary.

COMMISSIONER GREENOUGH:

I was trying to ask you very specific questions as to how you accomplish the social goals there are. Do you do it through mandating, limiting the investment structure itself, or do we go back to doing it directly through EEO, OSHA, laws, and the direct action where the problem is? That was the question.

MR. LaFLEUR:

I would say unequivocally that we should do it with direct action rather than with oblique, subtle, with a large element of wishful thinking that it is going to solve the problem.

I am concerned by the fact that if we talk about this developing -- there has been a lot of reference, first of all, to small business and promoting development within the state. I think what has to come first is the taxation and regulatory policies, and that structure.

Now, if you don't have a favorable climate there, what will happen is if you mandate that these retirement funds be used to promote economic development, you will just dissipate these funds. Then after you have dissipated them, you will come to the conclusion that something was wrong with our taxation and regulation policies; but by that time it will be too late.

Therefore, I think this thing has to be viewed totally. It follows that if the climate is right for the entrepreneur to begin, the capital will be there.

REPRESENTATIVE MOE:

It is a very important question. It is probably the central question in the whole issue of social investment. Whose values and whose self-interest are we promoting? That is why I urge the removal of the question of self-interest from these decisions. The prospect of a battle in this country over this gigantic pool of capital I think has enormous hazards.

I don't think that it would be of much value with respect to the kinds of social concerns that you mentioned -- industrial pollution and so on. I doubt that industrial employees are likely to be terribly effective in addressing those kinds of concerns. Since their interest in many cases parallel that of industry, profitability becomes very, very important.

My conclusion is, after some thought on this, that we can and should develop a set of principles that will lead all parties, or any party, any set of decisionmakers, to essentially the same kinds of decisions and same kinds of conclusions, and I think we can do that if we separate ourselves from this notion that we can accomplish some kind of immediate social good above and beyond that of providing for the retired employee.

CHAIRMAN CARTER:

I would like to take a crack at presenting the issue in a slightly different perspective, because I guess I am troubled by a different set of assumptions. Mr. Marcus, in his very eloquent statement and in subsequent remarks, refers to the large size and the natural tendency, therefore, to want to use the pension assets for a variety of purposes, although I don't quite follow the submarine-airplane metaphor, but up to that point.

I would put the proposition -- with the same caveats as Mr. Greenough, this is not necessarily reflecting my thingking -- that the pension system or the combination of pension systems and the accumulation of assets are themselves a distortion of

capital markets, and if one starts out with that assumption, then it seems to me a little odd, then, to talk about other activities interfering with the efficiency of markets in relation to the use of expenditure of these funds.

As a matter of fact, the study group under which egis these hearings are being held is to examine precisely that question: Is that true and the extent to which it is true.

But assuming that pension assets are going to grow at the rate described and become an increasing share of all capital assets, then the question arises, what needs to be done to limit the distortions caused by this particular aggregation of capital funds to capital markets? It doesn't seem to me a sufficient answer to say, leave investment managers alone to do their thing.

To retell, as Mr. LaFleur has done, the many instances of problems faced, I think is useful and informative, but only if it is going to help us try to fashion ways in which -- when I say "su," I don't mean necessarily the Commission, I mean all of us collectively -- fashion ways in which the society can be responsive to what is clearly going to be an increasingly controversial issue and serious problem in the society, in the economic aspect and political. Therefore, I guess I am not so much troubled by the difficulty of the questions and issues raised -- I really feel very instructed by them and clarified in the sense of understanding more what is involved in some of the questions that we may propound so simply -- but I am troubled by the lack of apparent response to these issues and questions and the apparent general drift of testimony that -- with some honorable exceptions-- that what we are doing is probably the best that we can do and we have to look for answers somewhere else, inexplicitly defined.

Any comments I would be very happy to have.

MR. LaFLEUR:

Please don't misunderstand my comments, Mr. Chairman. I do have some thoughts on what can be done.

The question you raise is the fundamental one that once we created the public policy of retirement plans, we created a distortion in this mixed economy that Mr. Greenough referred to. It is a form of forced savings, and once we set up the mechanism to do that, we created another intermediary.

I guess the thing -- I am not advocating that we just let well enough alone and not do anything, and that everything is perfect. I don't admit that the markets are perfect, but I think we are moving in that direction. The markets have enough self-correcting factors; if you allow them to work, they will move in that direction. So what is needed is patience and increase the number of options that are available to an investment manager. That is what we are interested in. We are interested in new ways to make money. We are receptive to the new ideas. So perhaps this

runs to, let's take more of a total portfolio view. I would definitely be in favor of that.

But what we are concerned about is some kind of a mandate that someone will in some kind of elitist fashion say, "We think that's good and we think that's bad," and direct flows into those areas, try to remove as many barriers as possible to the free flow of capital.

CHAIRMAN CARTER:

Thank you.

MR. MARCUS.

I would like to second that. The question you raised is, of course, crucial and fundamental. When Mr. LaFleur translates this whole social investment concept into people suggesting that we ought not to defer to much of the benefit to the future and take some of it in the present, there is a basic underlying social philosophy that has to be looked at here, as well as an economic one. That is that if the individual feels that he would like some of it now rather than later, that is the American individual privilege; but the basic reality is that -- and this, as you all know better than I do, is the mandate to some degree of the Commission -- if the subject, the problem of retirement, the future, is not solved today, we are going to come upon a period of time -- and I think it is by now 27 years -- when the post-war knot of population moves into the retirement mode, and if these people cannot have some retirement structure of security, it will grossly distort the economic structure of the country. That is a basic reality and that is a consideration that has to be made here.

At the same time, this business of mandating investment and the distortions in the capital market, you are looking for answers that have to be sought, but I am suggesting that the first thing to know is what the answers are not. The diversion of investment of a pension fund capital into subisdiary areas that have nothing to do with pension retirement is the wrong answer, and you are not going to find the right answer until you know what the wrong answers are. Let's get this whole social investing concept out of the way. The money belongs to the beneficiary.

I guess I am particularly bothered by the issue of displacement as a kind of a topic that we need to nail down at the Commission. Particularly in light of much of the discussion that we have had today and to some extent yesterday, we focus largely applied to sort of efficient market theory to displacement among large institutional investors.

So I guess I would like to know more from your studies, and particularly yours, to what extent there is a self-correcting mechanism and to what extent we still have vacuums there created possibly very directly by a pension policy.

MR. MARCUS:

I think that really the greatest problem that the Commission faces in addressing these questions is the danger of failing to recognize that what we are dealing with is a dynamic economy and dynamic capital markets. To try to solve problems by developing programs is a serious mistake, because programs address themselves to specific problems and the problems change and the programs stay in place.

Over the next decade the configurations of the capital markets and the structures and mechanics of capital markets are going to change appreciably. The effect, for example, of the SEC proposals for the national auction market, nobody knows what effect that is going to have. There was a meeting of the Securities Industry Association in Florida last week and the appalling report was that these investment people weren't even concerned with it and didn't know very much about the Cincinnati exchange experiment. The industry itself is primitive.

If the dynamics of the capital markets and the dynamics of the economy are going to continue to change, in the same situation where the pension fund assets continue to grow -- and will, of course, impact seriously the capital markets -- then it seems to me that the Commission has to address itself not to programs, but to find ways to deal with the dynamics of change, and how you are going to do that, I don't know.

The Use of Pension Assets to Promote Union Interests

THE USE OF PENSION ASSETS TO PROMOTE UNION INTERESTS

MR. POULIN:

Thank you, Mr. Chairman. Members of the Commission, my name is Claude Poulin. I am the Assistant Director of the Social Security Department of the UAW, International Union, and with me today is David Hirschland, also of the UAW Social Security Department.

I would first like to say that the title of the topic, "Use of Pension Assets to Promote Union Interests," in our minds means that pension assets should be used to promote our members' and the pension fund participants' interests.

An independent trustee appointed by the company manages the funds and the union has no say in the appointment of the trustee. The trustee has sole responsibility for the investment of the fund's assets. We view the independence of the trustee as very important. Supporting the independence of the trustee does not prevent the union from taking an active interest in the quality of the trustee's investment decisions.

The union is responsible for advocating the interests of our members in the largest sense. This responsibility of the union extends beyond the triennial bargaining of pension benefits and encompasses the entire structure of the negotiated pension plans, including their role as ready sources of capital for investment.

We believe that the social utility of an investment should be considered when applying the standard criteria of liquidity, yield and risk in determining the desirability of an investment. Unfortunately, the experience has shown that this criterion of social utility never had any role in the trustees' investment decisions.

I would like to briefly describe the agreement that we had with Chrysler. There has been confusion as to the tenor of the agreement with Chrysler. It was reported last week, for instance, in Pensions and Investments that the fund had agreed not to invest in companies which were not of UAW liking. I would like to correct the record and specify that this only applied to companies which have businesses in South Africa and which do not endorse the Sullivan principles.

This recent agreement with the Chrysler Corporation provides that up to 10 percent of the net annual income to the UAW Chrysler penson fund will be invested in residential mortgages and debt obligations of nonprofit nursing homes, nursery schools, federally-qualified HMOs, hospitals, or similar nonprofit institutions in a few targeted communities where there are high concentrations of UAW members. The communities to be targeted will be selected by a joint committee annually.

The residential mortgage component of this new agreement will be focused primarily on single and multiple family dwellings, including cooperatives and condominiums, the purchase price of which is equal to or below the average purchase price of similar housing in the communities involved. Mortgages will not be limited to UAW members, but will be offered to the general public in selected areas.

Investment opportunities in residential mortgages, as well as those in socially useful, nonprofit enterprises, will be recommended by the trustees of the pension fund by a newly-established investment advisory committee composed of six members, three appointed by the corporation and three appointed by the union. In the event the members of the committee are unable to reach agreement on the recommendations to the trustee, the impartial chairman of the UAW-Chrysler Appeals Board will cast the deciding vote.

It should be noted here that the actual independence of the trustees has not been radically altered. They continue to have full investment discretion and are bound by the law to exercise that discretion in a prudent manner. The concept of the investment advisory committee does, however, provide the union the opportunity to influence investment decisions made by the trustees.

Both the recommendations of the union and the investment advisory committee must be considered by the trustees, but they are not bound by these recommendations and they may reject them if they conclude that the recommended actions are inconsistent with their fiduciary responsibilities under ERISA.

The UAW-Chrysler agreement in no way jeopardizes the integrity of the pension fund. Further, it is the hope of the UAW that exposing the trustees to investment opportunities in socially-desirable areas will expand their investment criteria of risk or safety, return, and diversification to include social utility.

This agreement with Chrysler will not dramatically change the investment policy of institutional fund managers. We believe that it is an important first step in assuring that the funds which provide benefits for our members are invested in a manner which recognizes social utility. We will, of course, monitor the Chrysler experience, as well as the other pension funds where

we will have similar agreements over the next few months. We are confident that other institutions will begin to look seriously at this area now that this precedent has been set.

As the value of the assets of pension funds continues to increase in the coming decade, the questions of how these funds will be invested will become increasingly important. We expect that more and more the answer will include the type of investment strategy we have outlined today.

MR. SIDELL:

I am William Sidell, the General President of the Brotherhood of Carpenters and a Vice-President of the Building and Construction Trades Department of the AFL-CIO.

I will direct my remarks to the role of so-called social factors in investment choices and the role of unions and labor and management trustees of collective bargaining plans in making those choices.

What once was a mole hill is now a mountain. Today private pension funds exceed $280 billion. By 1986 they will exceed $1.3 trillion. We are aware of the tremendous potential for good held by these funds. We are also aware of the potential danger of abusing such massive amounts of capital. I think it is important at the outset to define for discussion what I mean when I refer to "social investment" or "social factors." In the context of a pension plan, whether it be a collectively bargained plan or an employer sponsored plan, I am referring to investments that will not only provide earnings to fund retirement benefits, but will also help assure that the plan is still ongoing by the time the participant is ready to retire. I am not referring to investments aimed at fulfilling short term social goals or private interests.

We have all heard or read recently about investment of union pension funds in anti-union companies or in companies outside the jurisdiction of a given plan that serve to erode the foundation of our plans. Generally these investments have been made by third party investment managers who receive no guidance from the funds as to how investments should be made. As a result, plans have been funding their own demise by financing, for example, multinational companies that will transfer its operations abroad and swell the ranks of unemployment at home. While the earnings from such investments may be beneficial for pensioners today, such investments undercut the pension opportunity for pensioners tomorrow.

Collectively bargained plans are primarily funded by employer contributions which are computed by multiplying a given rate times the number of hours actually worked. A stable work force is obviously essential to providing future benefits. If

the work force is diminished, thereby eroding current contributions, pension promises are unlikely to be fulfilled.

In this context, social investment becomes more than just a factor that investment managers may consider when making investment decisions. The fiduciary rules under ERISA obligate those responsible for making investments to do so solely in the interests of the participants and their beneficiaries, and for their exclusive benefit. If a fund invests in a company, the actions of which subvert jobs which are the basis for fund contributions, can it be said that the investment was solely in the interests, or for the exclusive benefit, of plan participants? Clearly an investment that undermines the health of the fund cannot comport to fiduciary standards. Consideration of such long-term financial considerations, then, is not only a factor that may be taken into account; it is reprehensible for a fiduciary not to take it into account.

Unfortunately, to date these social factors have been largely ignored. As union officials who represent the interests of employees, we can no longer permit this issue to be neglected in union pension funds. Unions have a responsibility to represent employees' interests concerning wages. It has long been recognized by IRS that pensions are deferred wages given special tax treatment to encourage development of retirement funds. As such, they are a mandatory subject of collective bargaining. It should be the role of the union to effectuate the best use of union pension funds to fulfill the retirement needs of its members. This can only be done by taking action to insure that an employee's pension fund is a dependable source of benefits when he or she reaches retirement.

I am a trustee of a pension fund and I take the obligation seriously. I have no right to risk the retirement security of the participants in that plan. That means that I can no sooner invest in pension fund assets for my own personal social objectives, no matter how maritorious they may be, than I can invest in some speculative venture which might jeopardize the assets of the fund.

On the other hand, investments of a union carpenter's pension fund in union construction not only is a sound investment for any portfolio, it will stimulate the base of economic activity needed to continue to fund the plan in the future. Simply stated, if the choice exists between two investment vehicles which are of comparable short-term benefit to the plan, we need to use our funds to create jobs in that part of American industry which employs our participants.

MR. FREEMAN:

My name is James Freeman. I am a Vice-President of Union Carbide Corporation. I am here today on behalf of the Business Roundtable.

Let me begin by voicing our overall concern with any deviation for any reason from the principle that private pension fund assets should always be used for the primary purpose of providing retirement income security for the participants. This principle is even more important today than in past years when it was not even an issue. Why?

First, the majority of private pension plans today are not fully funded to meet the liability of already-earned benefits.

Second, the present high degree of inflation is seriously impacting the buying power of current pensions being received.

Third, the soundness of public pension plans, including Social Security, is open to question.

Fourth, the increasing ratio of retirees receiving benefits to the working population puts additional pressure on both the public and the private systems.

Fifth, the high expectation level of our current society -- in other words, increasing current level of benefits -- is still with us and, to the extent they are granted, will further increase costs.

In other words, I feel strongly that if we have to err, we should err on the side of prudence.

Additionally, while investment strategies as well as social strategies change over time, it is much easier and certainly less emotional to adjust asset distribution to different impersonal financial directions than it is to turn off funds or withdraw funds from a myriad of objectives no longer viewed as socially valid or financially viable.

MR. SEBASTIAN:

I am Hal Sebastian, Manager of Benefits for the Standard Oil Company, Ohio, or, as we call it, SOHIO. I am here representing the National Association of Manufacturers in my capacity as a member of its Committee on Employee Benefits and Compensation.

The National Association of Manufacturers has a vital interest in all aspects of pension policy, including the ownership and control of pension fund assets and the use of pension assets to promote union interests.

Actually there has been very little exchange among businesses on the concept of social investing, and little, if anything, has been published by the business community on this subject. However, we are vitally interested and concerned, and believe that the entire issue of achieving social responsibility through pension fund investing deserves a great deal of further examination.

The NAM believes that the purpose of the pension plan is to provide retirement security for retired employees and that this is in itself a major social function. Preserving this retirement security through prudent and sound investment practices should be the ultimate goal of any pension manager.

With this in mind, the NAM believes that pension fund assets should not be considered as a panacea for the nation's social and economic ills. Therefore, the NAM cannot accept the use of pension fund assets to rehabilitate areas of the country in economic decline, nor can it accept the use of pension assets to promote union interests unless such investments first and foremost meet the test of responsible investment decisionmaking.

Some union leaders are embracing the concepts of social responsibility as a means of gaining control over the largest source of investment capital in the United States today. In the private sector alone, as has been brought out here, pension fund assets total some $280 billion are are growing at the rate of 10 percent a year.

Diversification of the pension portfolio is extremely critical, whether the investments are made locally, regionally, or overseas. Concentrating too much of a pension portfolio in one geographic region or location, whether it be to stave off economic decline for an already depressed region of the country or to promote the interest of organized labor, weakens the principle of seeking market return and may even undermine the investment requriements provided for under the Employee Retirement Income Security Act, or ERISA.

Therefore, one must remember that the ultimate purpose of the pension plan is to provide retirement security and that that purpose must be preserved through investing to make the highest rate of return the lowest possible risk.

We must keep in mind that a bad investment, whether it is socially responsible or traditional, is still a bad investment. Good investments can arise from either source.

Now, another area of concern to the employer is the question of where does the employer's responsibility begin and end with social investing? For example, if union leaders or public officials direct pension investments to so-called socially desirable or responsible area that fail to yield an equitable return, who is held liable for the losses? Who has to make up the difference? The fund sponsor or the invystment manager? In most cases, if the investments do not pan out right and if the pension plan has been negotiated, the fund sponsor has promised in some way to pay a pension, then the fund sponsor has to make up this difference. The union is not going to make it up. The government is not going to make it up unless the company goes under, the PBGC, hoping that it will still be alive, might be able to make it up.

So the NAM strongly believes that wherever we choose to vest control of the decisionmaking authority, we must insure that the responsibility for bad socially responsible or desirable investments is similarly vested.

There are many questions, which I do not have time to address today, which must be resolved before the NAM can even consider supporting changes in pension investment decisionmaking policy. Until those concerns are adequately resolved, the NAM believes that the current guidelines of maximum return for minimum risk must continue to be followed in both traditional and non-traditional investing, and that the investment manager must continue to be prudent under the most stringent definition of that term, and that balance and flexibility have proven to be essential components of any pension policy and, therefore, should not be altered.

The NAM firmly believes that the integrity of the pension system must be preserved, including fiduciary standards, responsibility commensurate with authority, balance, flexibility, and diversification, to name a few. Otherwise, we would seriously jeopardize the financial integrity of pension plans, and with that jeopardized, the benefits workers expect to accrue upon retirement.

MR. SEIFMAN:

My remarks were prepared on the basis that I believed as an attorney I was going to be on a lawyers' panel, but I think I can deal with the subject matter of this panel.

I am a partner in the firm of Seifman & Lechher, and we are special counsel to the United Food and Commercial Workers for pension matters.

The government of the United States has been in the business of social investing for years. One merely has to look at the tax laws that have been structured in this nation to see that is a fact. For an example, Congress passed laws providing for a five-year amortization for railroad cars and pollution facilities.

I do not believe that a proper subject of this panel is investing pension fund money for union benefit. We are concerned with utilizing the deferred wages of our employees who are members and who determine the allocation of wages to be used currently, as opposed to being deferred into their own pension plans, to be used for their own benefit.

I believe our members, employees and participants would be greatly disheartened if they saw the degree to which pension fund money is utilized to support companies which are not unionized in our industry. The support of these companies puts them at a competitive advantage as compared to organized companies and will have a dramatic effect eventually, if this actually resulted in

any significant economic effect, on the survival of the pension system as a whole.

As Mr. Sidell has said, these monies are used for jobs in the construction industry. Pension contributions are determined on the amount of hours worked in many industries in this country. If you take away union jobs for the unionized retirees that we are all trying to benefit here, there will be much less money available for their retirement. Contributions are based on work. If the employee base decreases due to not using these resources in a fashion to increase the competitive advantage of unionized companies or the wherewithal of the worker and the availability of jobs, there will be a large decrease in the wherewithal of pensions, a burden placed on the Pension Benefit Guarantee Corporation which will ultimately translate into much higher premiums for the nonunion companies that many of the people here are concerned with.

I believe that the unions can live with existing laws, that our primary purpose is that we act solely in the interests of participants and beneficiaries, and I believe the definition of prudence can take into consideration social factors and we can seek out alternate inverstments or nontraditional investments which may benefit our employees to a much greater extent than they benefit in investment in the stock market. I believe that the stock market has not given our plans a fair return, and in the interest of prudence our trustees will have to seek out alternatives, anyway. We are very interested in the concepts developed by the United Auto Workers.

I believe that using the resources of our plans to enhance the competitive advantage of nonorganized labor will ultimately result in hampering the growth of our plans and the growth of the retirement benefits we all expect.

In conclusion, there was talk about forced savings in the past panel. The members of Congress have taken very great steps lately in endeavoring to even increase the savings in this country, as I stated before. New concepts, like ESOPs, TRASOPs, GSOPs, SRAs, IRAs, and LRAs have been developed to encourage employees to save.

Now, the country needs this money, I believe possibly that the right investment vehicles have not yet been developed for pension funds to be able to use the resources they have in the most socially desirable and economically attractive means available.

COMMISSIONER LYONS:

Well, what do you see that flies in the face of that proposal that he suggested up there which is in reality to do social good with pension plans and, at the same time, enchance the benefit of the participants that is different from your identification of violation of the law?

MR. THOMPSON:

Well, the study that I have made, and I think that practically everyone else who has really gone into depth on this subject concludes, is that when you start making investments from the standpoint of what is socially good and what is socially ungood or bad, you run into the problem of a potential conflict between what is in the best interests of the beneficiaries of the plan. You can assume that one thing is socially desirable, I can assume that another is.

For example, we were told earlier before you arrived that to invest money in luxury apartments -- at least I understood this to be the case -- pension money in luxury apartments which the union members probably couldn't afford. Nevertheless, directing those funds toward low-rent housing was a socially desirable investment.

I suggest to you, as a gentleman who comes out of the building trades unions, that the people who build those luxury apartments are just as worthy of consideration, those workers, as are the builders or the workers who build the low-rent housing. And when you determine socially that you are not going to invest funds in construction of luxury apartments, you are making a determination that adversely affects working people as well as investors or promoters.

A better example, I would suggest to the Auto Workers, is say should you invest in General Motors, or Chrysler, for that matter, when they make those awful luxury automobiles that those rich people ride around in? And yet those Auto Workers who build those automobiles benefit from those investments, I assume.

COMMISSIONER LYONS:

You commented upon the New York City pension's use of not bailing out the City. Do you think that was either wrong or illegal?

MR. THOMPSON:

I think it was legal because Congress made an exception for the New York pension funds.

COMMISSIONER LYONS:

Was it a wrong use?

MR. THOMPSON:

I think on a long-term basis it was a very dangerous and, therefore, a wrong use, because I think the likelihood of the beneficiaries of those pensions, of having their pensions when they reach retirement age is in question, and I think that is a highly questionable use of pension funds.

Short term, with some governmental guarantee, as I recall the temporary arrangement was, I would have no serious problem with. But long-range investment by a pension fund in such things as the shaky governmental structure of New York City, I consider highly irresponsible.

COMMISSIONER LYONS:

Of course, the decisionmakers on that said, "if it's long-range shaky, it's down the tube tomorrow." And there was a choice of the two.

MR. THOMPSON:

Let me just add on the New York situation, I don't think New York City is likely to go out of business. I don't think the City is going to let it. When you have a situation like they had, there was government support of those programs on a short-term basis. I have no quarrel with that.

COMMISSIONER LYONS:

I have listened to a lot of people who were involved in that that are pretty proud of the fact that they think they saved New York City.

MR. THOMPSON:

Well, they may have saved the financial structure of New York City as we know it. I can't picture that the city would just evaporate.

COMMISSIONER LYONS:

No, I am sure of that.

Let me ask you one final question, if I could.

You kept referring numerous times to changes in the law had been suggested that you opposed. What specific changes have you heard of? I haven't heard of any specific changes in the law.

MR. THOMPSON:

Well, I think it would take changes in the law to make socially desirable investment progress, such as have been suggested, proper, particularly under the ERISA rules. For example, I highly question the conduct of a fiduciary, a trustee of a pension plan, or whatever, ruling out investment in companies that do business in South Africa, whether they subscribe to the Sullivan principles or not, just because they do business in South Africa. I don't think that is a prudent consideration for a fiduciary to take into account.

CHAIRMAN CARTER:

One of the things I am convinced of is that this term "social investing" is an effort to cut a piece of cloth to cover too many different things, and there clearly are many things that, if we looked at them more analytically and with less heat, I think we could get a wider area of agreement on many things that could in fact be done that are called social investing. Then there are others that would generate an awful lot of controversy because they do reflect more plainly particular values.

The reason I think that is important is that while people like to talk about neutral investing, it is also clear that investment managers have all sorts of preferences of their own. Now, they may not be called social preferences, but they do have preferences as to portfolio holdings, and the mix would be quite different from investment manager to investment manager. In that case, who bears the loss? Well, we obviously know who bears the loss, unless there is some evidence of clear acts of improper investment behavior.

It is going to be necessary, I think, in looking at this question to be less wholesale, whether you are a proponent or an oponent, in one's approach to the issue; and, if anything, I think we have tended on either side, whichever way we come out, to be too wholesale rather than looking at specific ideas and proposals in relation to our current practices, and, as I have tried to point out, and others have pointed out earlier, to the dominant position of the pension assets in the economy and, therefore, the fact that that in itself is not a neutral noninterventionist position; that is, that reflects a substantial distortion in the market which itself needs some kind of adjusting, and which we can't simply rely on ordinary market forces to correct.

But clearly all of the answers are not going to be found inside of the pension fund or its management, but presumably some of them will be found there.

The Portfolio Impact of Non-Traditional Investments

THE PORTFOLIO IMPACT OF NON-TRADITIONAL INVESTMENTS

MR. SMART:

I believe there is a significant difference between investing in the interest of the participant and investing in the interest of the fund. I submit that most fund managers, by their subjective decision to limit their criteria to such financial factors as risk and return, are looking only at fund security. While I believe that this is in the interests of the participants and beneficiaries as far as it goes, it does not go far enough, because those factors do not consider how the fund investments affect the daily lives of the participants and the beneficiaries. This is where the risk really is important.

A.G. Becker Company was commissioned to develop a model to determine the risk to the beneficiaries of Wisconsin's public retirement funds of investing more money in Wisconsin. In analyzing the risk, one of the key factors of Becker's analysis was the economic health of the employer. In fact, Becker defined risk using five key variables: the economic health of the employer, the funded status, market conditions, time horizons and investment risk.

Becker's categorization of risk is important because traditionally we have tended to look at risk from a financial perspective. Now I think we have to come to realize that with the participants' and the beneficiaries' interest, risk must be looked at from a much more broader perspective.

I would like to close my remarks with one observation, and that is the all-things-being-equal criterion that most of us seem to be in agreement about. Jim LaFleur, the investor of the Wisconsin Investment Board and I have had discussions on this, and this is one point that we are in agreement on; that is, rarely, if ever, are two investments of equal merit. That may be fine for discussing purposes, but when it comes to practice the money is going to be available for the investment, the investment is going to present itself, and you are just simply not going to have an opportunity to invest in an equal yield/equal risk situation, one being in Wisconsin and one being in Illinois. I only mention that because I think we have to face the issue of socially beneficial criteria squarely and recognize that there is a cost and there is a benefit, and we should proceed accordingly.

DR. LOVE:

The thing I would like to address first is who owns America's private pension assets? By ownership, I am talking in terms that an economist would think of. I mean those who bear the consequences of changes in market value.

Basically the ownership effectively accrues to whoever bears the risk of those assets. What are the consequences of a change in value of a company's pension plan assets? Well, if it is a defined contribution plan, the plan assets can support greater or fewer benefits as the plan asset values change; and, therefore, by definition the economic owners are clearly the employees.

In the case of defined benefit plans, however, things are much more complicated. The consequences of a decline, for instance, in the value of plan assets run as follows: First, the future contributions must be higher and, all other things equal, future dividents lower to maintain the funded status of the plan. Consequently, the economic risk of poor performance of plan assets is transmitted directly to the stockholders of the firm. For sick companies, there arise significant probabilities, as asset values in the plan decline, that some benefits will not be received. These are basically three kinds: nonvested benefits, benefits that are currently in phase in status, and benefits in excess of PBGC maximum.

Finally, the probability also begins to increase that other American companies, other than the plan sponsor, will be assessed by way of PBGC premiums to pay vested, guaranteed benefits in termination.

Notice here that I do not talk about the PBGC paying the premiums. The PBGC, we should all know by now, does not have access to public taxpayers' money. It is merely a private assessment program whereby losses incurred by one comapny in its pension plan are transmitted to other companies in American industry. This brings me to the following point that is seldom recognized under ERISA, and that is that vested, covered benefits will be received independently of the value of plan assets. Hence, most plan participants' benefits are not at risk and, consequently, most employees no longer have economic ownership in defined pension plan benefits. Their risk, the risk burden of ownership, has been shifted via the PBGC and ERISA to corporate America at large by way of the premium system.

ERISA itself in its provisons does recognize stockholder ownership of defined benefit plan assets in the following two ways at least: First, ERISA clearly vests corporate management responsibility and authority for investment policy and its implementation in appointing money managers, performance measurement, et cetra, with the corporation; second, it is clear under

Title IV of ERISA that the liability for PBGC guaranteed benefits, net of plan assets, is a corporate liability. Thus, if pension liabilities are corporate liabilities for defined benefit plans and managment is responsible for the management of the plan assets, clearly plan assets are corporate assets.

Now, I would like, if I can, to consider this presentation to be in two somewhat independent parts. The first has to do with what are the economic issues and who owns pension assets? The second has to do with some specific issues related to socially responsible investment. The two have bearing on each other, though they can stand independently. Socially responsible investment is what we pay taxes for. Socially responsible investment is a tax which transfers wealth from constrained investors to unconstrained investors while reducing output and wealth at the margin by allocating capital less efficiently than would an unconstrained capital market. The economic ownership of plan assets does not affect the impact of any such taxes, but only who pays them. Now, I am not saying that taxes are bad. Taxes are a good thing. We have a lot of them and we wouldn't have had a lot of them for such a long time if at least most of them weren't good taxes. But what do I mean by a good tax? Good taxes have certain properties. For one, they are explicit. They are done with public knowledge, public support, and the people that are taxed are informed who they are. Second, the cost and benefits of taxes should be appraised as to who bears them, how much they are, and what effect they have in what good they do or don't do. I am not sure that socially responsible investing meets those criteria.

The public is now complaining vociferously about taxes by the front door. I am wondering how willing they are to pay taxes by the back door via way of concepts such as socially responsible investment.

Finally, I believe that socially desirable investing should be a non-issue. The trustees of plan assets should retain their responsibility and authority to respond to these issues voluntarily. If the unions and the employees want to invest their money in companies which favor unions, that should be their business, and similarly otherwise.

The government should pass no laws which restrict freedom of choice which have the effect of a tax or subsidy where it is unwilling to vote explicitly such a tax or subsidy.

MR. LITVAK:

Members of the Commission, my name is Lawrence Litvak. I am an economic consultant currently involved in several projects relating to nontraditional considerations in pension fund investment. I would like to divide my comments into two general areas.

First concerning the portfolio of facts of excluding investments for social and political reasons, and secondly dealing with the portfolio of facts of emphasizing local economic development enhancing investments.

While working with the Council on Economic Priorities on a study commissioned by the State of California I have had the opportunity to study possible effects excluding EEO violators and companies with South African operations from public employee retirement system portfolios. In general, I concur with the conclusions of Professor Andrew Rudd, which he is going to discuss in detail in a momemt, as to the pretransaction cost effect of excluding a sizable number of U.S. companies with South African connections from a passively managed equity portfolio designed to track the market. Modern methods of portfolio optimization permitted an investor to construct from a subset of securities a portfolio that virtually eliminates all residual risk. In this sense, exclusion does not interfere with the efficient minimization of risk. In fact, the tiny residual risk found in an equity portfolio optimized out of the 383 firms in the S&P 500 not investing in South Africa may overstate the problem.

Some of this residual risk will be eliminated when the equity portfolio of the pension fund is combined with its bond and mortgage portfolios.

While the ability to still effectively diversify after excluding a sizable number of companies has only been documented for the equity market, it seems reasonable to extend the conclusion to the bond market, as well. A much smaller proportion of the risk in a bond is residual, nonmarket risk, making exclusion of the typical bond less costly in terms of lost opportunity for diversification.

However, these conclusions do not answer all of the possible objections to exclusion that might come from a portfolio manager. To begin with, the pension fund might want to hold a equity portfolio more or less volatile than the market as a whole in pursuit of higher returns or lower, but safer, returns.

Stocks that would go into such portfolios, either relatively high or low market volatility ones, usually have a greater than average proportion of residual risk. Thus, efficiently diversifying such a portfolio from a postexclusion list of securities may be more difficult than is suggested by the case where a portfolio of average risk is to be constructed.

The next objection is what I would describe as a more philosophical one, although it may or may not have real implications. While exclusion may not impede building a core passive portfolio designed to track the market, as the argument goes, it will hamper so-called active management biasing the portfolio towards undervalued stock. I do not believe this is a serious problem under current pension fund investment policies. While

few people argue that the securities markets are completely efficient -- and I will momentarily argue that they aren't -- there is strong evidence that certain companies grouped together constitute a relatively efficient market where stocks and bonds tend to be appropriately priced in relation to risk and return. It is precisely this efficient sector where most pension funds make investments and where the companies that would be the target of exclusion raise their capital.

Substantial research has shown that very few institutional investors consistently outperform the market on a risk adjusted basis. If securities in which pension funds invest are priced appropriately, then we do not have to worry that a boycott list might prevent portfolio managers from holding assets promising a return over and above what similar risk investments pay. The opportunity for loss simply does not exist in these circumstances.

The final objection to exclusion concerns the transaction costs involved in divesting of any offending securities in the portfolio and then restructuring through new purchases. I am not prepared to estimate the range of these costs which occur in the form of both commissions and dealer spreads.

Due to the growth of negotiated commissions and block trading, these costs are much lower than they would have been a few years ago. In general, the more amount of time a fund has to restructure its portfolio once an exclusion policy has been adopted, the more easily can transaction costs be minimized.

I would now like to turn to what I refer to as developing enhancing investments. Developing enchancing investments are advocated for pension funds with the intent to boost job and income creation in a city, state, or region.

I recently authored a book on state government innovations in develop finance which gave me an opportunity to examine the match between possible pension fund investment and capital needs for subnàtional economic development. Use of pension funds to stimulate economic development is frequently -- and I think mistakenly -- taken to be synonymous with making concessionary investments; that is, providing capital at below market rates in order to attract or retain business. If capital subsidies are to be used to compensate for distressed areas market or production cost disadvantages, these subsidies will have to be quite large.

The subsidy incorporated in tax exempt industrial revenue bonds, for example, generally has not been effective. In Europe and Canada, where locational subsidies have been more effective, they have had to be 20 percent or more of the total capital cost per employee. Thus, an approach to development enchancing investments relying on concessions involve substantial loss in retun for a pension fund unless the loss is made up to it by some governmental unit.

Part of the identification of development oriented investments with concessions stems from a view that all financially competitive enterprises in any area are already being funded by the capital markets. Thus, anything pension funds invest will simply be displacing some other source of capital with no additional job or income creation. I believe this view represents an extension of the efficient market hypothesis beyond evidence.

What is true for securities traded on the New York Stock Exchange is not necessarily true for other segments of the financial system. There do exist investment projects in any region that can pay a competitive or better risk adjusted return and create additional jobs and incomes that are not being financed due to capital market imperfections. These investments tend to be mainly in smaller companies; that is, ones that have assets of a few million dollars at most as opposed to tens of million dollars or hundreds of million dollars.

Evidence on market imperfections that deny capital to productive firms include the developing body of research showing that local banking market concentration leads to underfinancing of small firms, that public regulation of financial intermediaries unnecessarily impedes investment in these companies, that small manufacturing enterprises as a group are relatively profitable, and small firms often merge with large companies because of unjustified capital availability problems.

To be able to make a conclusive statement about how suitable these underfinanced enterprises are for investment by pension funds, we would have to know more than we know right now. However, I think some general observations can be made.

Even though these investments can offer compensatingly high returns, as a group they are riskier than the companies in which pension funds typically invest. However, because pension funds have a relatively long time horizon for investment and many will be adding rather than withdrawing principal for years to come, they are better suited than most financial intermediaries for bearing this market volatility.

For this same reason they are in a comparatively good position for tolerating the illiquidity that long-term data equity investment in smaller enterprises would imply.

The major obstacle to pension fund investment in small companies would appear to be transaction and information costs. Many pension funds even shy away from direct placement investment in larger companies because of their inexperience in evaluating and negotiating directly with borrowers. I doubt that many funds would generate a large enough flow of small company opportunities to achieve economies of specialization in dealing with these firms. The long-term solution to this problem may

lie in pension funds investing through other more specialized financial intermediaries oriented toward the smaller deal. Such intermediaries include venture capital companies, mutual funds specializing in the issues of small firms, special purpose state chartered but privately capitalized institutions, like the Massachusetts Capital Resource Company, and public financial intermediaries, like the Connecticut Development Authority.

As a final comment on the issue of pension fund investment in underfinanced small companies I would like to note that a member of the Commission, Mr. Greenough, summed up the situation quite well in a book he coauthored. I quote: "By concentrating on the offerings of major corporations, the funds may thereby be underutilizing the substantial opportunities for long-range, productive investments in small companies and for new and emerging enterprises, as well as helping to cause a shortage of capital funds for these concerns."

COMMISSIONER GREENOUGH:

I have already indicated that I don't believe in a perfectly efficient market; there are inefficiencies as you move anyplace. However, there are a lot of very sophisticated investors trying to take care of these inefficiencies all the time. So whenever you introduce a social factor do you merely displace one lender for another? Do you really accomplish anything other than within that rather narrow limit of inefficiencies, or is it mostly just displacement?

DR. LOVE:

If you constrain the flow of funds in any mandatory way, what happens is that money will still flow there from people who are not constrained and they will get windfall profits because others are constrined from playing in that area. So when you set up these mandatory barriers to funds flowing in certain directions, what happens is it creates windfall profits for those who can avoid those barriers and it does constitute somewhat of a tax on the people who are prohibited from investing in certain areas. The tax really amounts to a wealth transfer between the two kinds of investors.

DR. RUDD:

That is exactly true. If sufficient investors are excluded from one segment of the capital market, then the effect of that is to make the other investors keener to buy those stocks. In other words, the market provides an inducement to the other investors. So one of the perverse results of, for instance, diversement would be to make those divested stocks better investments for the investors who aren't excluded from purchasing them. Now, that would be under the condition that there were a sufficiently dominant set of investors who were excluded. If it was just perhaps one or two, then that wouldn't occur. But if there were sufficient investors, then it is true that there are profits to the people that aren't constrained from investing.

COMMISSIONER GREENOUGH:

It seems to me the conclusion of what you have just said is that all of this activity in social investing and so on doesn't avail of anything. If you merely displace good investors with bad investors who come right in and get financial advantage by so doing, then the results of the whole effort have been perverse instead of positive.

DR. LOVE:

I think it is very much like the Iranian situation. Somebody proposed, "Well, why don't we stop shipping them food?"; whereupon some reasonable analysts point out that if we stop shipping them food, there are others in the world that would be most willing to ship them food and make a higher profit precisely because the United States is out of the market of shipping food to the Iranians. It is very much like that.

MR. LITVAK:

If you are arguing that boycotting companies because of their anti-social practices simply leads to a transfer of return to other investors as a result of undervaluation of those companies' securities, I think while that may be true in the financial dimension, there is a whole political dimension to the boycotting of those companies that we haven't really talked about, and the positive impact of that in changing the behavior of those corporations may in fact show some effect. So it is not just a pointless exercise.

MR. WOODRUFF:

An argument was made that by altering the risk profile of the firm that you are excluding your investments from, if your investments were significant enough, that you could, in fact, change the economic conditions of the firm itself rather than the stock that is being issued. I think you focus completely on the stock, the value of the stock and the impact in shifting return or yield for investors.

DR. LOVE:

Well, if society doesn't like what particular companies do, why doesn't it just tax them? I mean, that is what we did with cigarettes. That is what we are doing with liquor. I mean, why go through all this social responsibility stuff? If society really doesn't like what a company is doing, then either put it out of business or tax it? But why go through this completely circuitous, ambiguous route that causes we know not what and may not work, anyway?

CHARIMAN CARTER:

Would you say that the normal investment, traditional investment, practice in social investment would only be one that would not be justified within normal traditional investment practice?

MR. SMART:

I think what you are referring to is my comment in terms of all things being equal. I think that there are very few choices that would ever be so simply presented to a fund manager that he can say, "Here's one that's in the interest of the participants and here's one that isn't, but the financial criteria are equal."

CHAIRMAN CARTER:

Well, let me ask you the question this way: If you are making judgments every day and the question of prudence arises, presumably you are making judgments among things that are relatively comparable, among which distinctions as to choosing one or the other might lead you to some subsequent charge of being imprudent even though your best judgment using your quantative measurements brings you out to select one. If you had selected another one in your portfolio, it would not have been said to be an imprudent investment on its fact or in relation to the portfolio.

I am wondering whether all things being equal is not perhaps the wrong terminology for what is just an ordinary practice every day of the exercise of judgment, and one money manager might choose one particular -- you would have to assume that every money manager is going to choose exactly the same investment to add to a given portfolio on a given day in order to have the statement that I have heard really to be of consequence. But if you can conceive that different money managers can choose different investments in relation to the same portfolio on any given day, then all we are talking about is a range of purdent judgment within which selections could be made to add to the portfolio.

In that sense it seems to me all things being equal is, rather than the rather limited theoretical economic sense, is a useful concept. What we are talking about is the range of prudent judgments being made by money managers in relation to investments. At least that is what it would seem to me the practical sense of that term.

MR. SMART:

No problem.

MR. LITVAK:

The distinction I find useful is that while you may not find investments that are identical, you do find investments that are comparable. One investment may have higher risks, but have compensatingly higher returns. One investment may have relatively low transaction costs, but offer relatively low risk adjusted returns. So you do find comparability.

PART IV
APPENDICES

Appendix A
Forum Participants

FORUM PARTICIPANTS

Vance Anderson
American Bankers Association

Stew Baldwin
Council for Economic Priorities

James Ball
Arthur Andersen & Co.

Randy Barber
People's Business Commission

Mike Barker
Council of State Planning Agencies

Clyde Beers
Towers, Perrin, Forster & Crosby, Inc.

Paul Berger
Arnold & Porter

Barnet Berin
William M. Mercer, Inc.

Ernest G. Bianco
Meidinger & Associates, Inc.

Charles Bisset
Citibank

Zvi Bodie
National Bureau of Economic Research

Nathaniel Cabanilla
American Council of Life Insurance

Lisle Carter
University of the District of Columbia

Charles Cole
Steptoe & Johnson

Geri Colombaro
National Association of Manufacturers

Jack Cooper
Harris Trust & Savings Bank

Hal Coxson
U.S. Chamber of Commerce

Bernard Curry
Morgan Guarantee Trust Co.

Paul Dean
United Mine Workers Pension Fund

Richard Ennis
A. G. Becker, Inc.

Arthur Fefferman
American Council of Life Insurance

Karen Ferguson
Pension Rights Center

Larry Fisher
A. S. Hansen, Inc.

Peter Friedes
Hewitt Associates

William Gibb
American Council of Life Insurance

Chuck Ginzberg
Alexander & Alexander, Inc.

Eugene Glover
International Association of Machinists & Aerospace Workers

Hillel Gray
Pension Rights Center

John Harrington
California Service Employees International Union

James Hutchinson
Steptoe & Johnson

Rebecca Karnes
Bureau of National Affairs, Inc.

Kenneth Keene
Johnson & Higgins

Frank Klieler
Employee Benefit Plan Review

Marsha Kokinda
Employee Benefit Research Institute

David Kudish
Hewitt Associates

Michael Leibig
Zwerdling & Maurer

George Lingua
Citibank

Michael Locker
Corporate Data Exchange

Michael Lund
University of Maryland

Judith Mares
General Mills

John Mauhs
State of New York

Charles Moran
Manufacturers Hanover Trust

Michael Paisley
Liberty National Life Insurance

George Pantos
ERISA Industry Committee

Robert Paul
Martin E. Segal Company

Donald Peterson
Consultant

Tim Porter
AT&T

William Priest
BEA Associates

Ronald Ravikoff
Arnold & Porter

Jeremy Rifkin
People's Business Commission

Michael Romig
U.S. Chamber of Commerce

Dallas Salisbury
Employee Benefit Research Institute

Brooke Schearer
Sylvia Porter

Roy Schotland
Georgetown Law School

Bill Schweke
Conference on Alternative State & Local Policies

Clifford Simms
The Wyatt Company

Donald Smart
Wisconsin Center for Public Policy

Larry Smedley
AFL-CIO

Quentin Smith
Towers, Perrin, Forster & Crosby, Inc.

Kathy Spain
Municipal Finance Officers Assoc.

Scott Spencer
Unitd Steelworkers of America

Debbie Stark
Employee Benefit Research Institute

Douglas Stegner
Meidinger & Associates, Inc.

Les Stern
Pensions & Investments

Theresa Stuchiner
Kwasha Lipton

George Swick
Buck Consultants, Inc.

Chris Taylor
Corporate Data Exchange

William Thomas
Milliman & Robertson, Inc.

Catherine Thomson
Employee Benefit Research Institute

Jay Tower
Council on Economic Priorities

John Vaught
Frank B. Hall & Co.

John Wall
Republic Steel Corporation

Joseph Walshe
AFL-CIO

Albert Wilson
Teachers Insurance and Annuity Assoc.

John Windsor
Heritage Investment Advisors

Judith Wolfson
Connecticut General Life

Thomas Woodruff
President's Comm. on Pension Policy

Leah Young
Journal of Commerce

Appendix B
Sources of Information

SOURCES OF INFORMATION

1. Investor Responsibility Research Center (IRRC)

The IRRC is a Washington-based non-profit corporation founded in 1972 by a group of universities and philanthropic foundations to provide them with impartial research on social and environmental questions raised in shareholder resolutions. Since its founding, IRRC has expanded is research and information activities to include general studies of public policy questions, corporate governance issues, Securitites and Exchange Commission regulation of shareholder action, and analyses of the response by major institutional investors to all of these matters.

The IRRC is financed primarily by subscriptions paid by more than a hundred institutional investors, including banks and trust companies, pension funds, investment firms, insurance companies and church groups, as well as universities and foundations. It is governed by a board of directors, most of whom represent subscribing institutions.

The IRRC's publications and other services include:

- Proxy Issue Service, analyzing issues raised in shareholder resolutions and corporations' proxy materials;
- Newsletter Service, monthly publications reviewing all developments relating to social responsibility and investor action;
- In-Depth Research Service, occasional detailed reports on complex issues relating to corporate or investor responsibility, including social, economic, legal and scientific considerations; and
- Conferences, occasional meetings at which subscribers and other interested participants can discuss particular issues with experts.

The IRRC's services are available to all institutional investors. (The Treasurer's office investors currently receive the IRRC publications.) Subscription fees for the full package of publications and services are based on the market value of investments managed by the subscriber, and may be paid in cash or on a commission-dollar basis through any of 10 New York Stock Exchange member firms. The current fees are as follows:

INVESTMENT ASSETS	ANNUAL FEE
$25 million and under	$ 500
$25 million-$50 million	1,000
$50 million-$100 million	1,250
$100 million-$300 million	2,500
$300 million-$1 billion	4,000
$1 billion-$5 billion	4,500
$5 billion and over	5,000

The IRRC is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940.

Investor Responsibility Research Center
1522 K Street, N. W.
Washington, D. C. 20005
(202) 833-3727

2. Council on Economic Priorities (CEP)

The CEP was founded in 1969 to provide institutional and individual investors with documented reports on corporate activities related to social responsibility for individual firms in an investor's portfolio. These reports also compare the company's social performance with that of other large publicly-held corporations. The CEP has done extensive research on corporate activity relating to environmental protection, energy use, equal employment, defense contracting, consumer health and safety, politcial influence, and foreign investment.

The CEP's publications and services include:

- Portfolio Review Service, initial reports on the social performance of each company chosen by the subscriber (a minimum of 20 firms must be selected) with follow-up reports twice a year and additional analyses during the annual meeting season;

- Research publications, including CEP Studies, CEP Reports, and CEP Newsletters; and

- Briefings, occasional meetings at which investors can meet with researchers and company officials.

The Portfolio Review Service is available to all institutional investors. Current fees for this service, which includes all publications and briefings, are set according to market value of the investor's fund:

Asset Size	Start-up Fee (per firm)*	Annual Fee (per firm)*
Up to $1 billion	$100	$150
More than $1 billion	$150	$175

*Minimum twenty companies

The CEP is not a registered investment adviser, and does not recommend purchase or sale of specific securities.

Council on Economic Priorities
84 Fifth Avenue
New York, New York 10011
(212) 691-8550

250 Columbus Avenue
San Francisco, California 94133
(415) 989-7506

3. Interfaith Center on Corporate Responsibility (ICCR)

The ICCR exists to aid its member religious groups (currently about 15 Protestant denominations and 150 Roman Catholic bodies) in monitoring the social responsibility of corporation in which they invest and acting where necessary to correct corporate policy. Although the ICCR serves primarily religious groups, its publications have come to be highly regarded by institutional investors of all kinds who areinterested in issues of social responsibility.

Most of the ICCR's financing comes from member religious groups and from sale of its publications. It is governed by a board of directors representative of its membership.

The ICCR's publications and services include:

- Subscription Service, which offers the Center's monthly newsletter The Corporate Examiner, along with advance information about church-sponsored shareholder resolutions;

- Other Publications, special studies on such subjects as foreign investment, infant formula marketing in less-developed countries, military production, the employment of women, strip mining, urban redlining, and television programming, as well as on the practical aspects of developing a socially responsible investment strategy.

Most of the ICCR's publications are sold individually at modest prices; The Corporate Examiner is available for $25 a year per copy. The full Subscription Service, which includes multiple copies of publications, costs $250 a year.

Interfaith Center on Corporate Responsibility
475 Riverside Drive, Room 566
New York, New York 10027
(212) 870-2936

4. Corporate Data Exchange (CDE)

The CDE is a non-profit research organization created in 1975 to study economic concentration and the ownership and control of major corporations in the United States.

The heart of CDE's research has been ownership, rather than company practices, although CDE reports regularly on its research into such issues as redlining, job discrimination, political influence and insider lending by financial institutions. CDE staff researchers publish information about current practices in banking

energy development, agriculture, and transportation, as well as monitoring compliance with federal laws and regulations concerning fair employment and worker safety.

The CDE is financed by donations, grants, publication sales, and contract research for government agencies, labor unions, churches, public interest groups and the press.

CDE's publications and services include:

- Stock Ownership Directories, profiling ownership and operating data about major corporations in specific economic sectors;
- Special Handbooks, on loans by American banks in South Africa and on the holdings of public and private pension funds in companies that have been criticized for certain practices or repeatedly found in violation of federal regulations;
- Company Profiles, profiling data on the ownership and operating practices of specific firms, either from the CDE's computerized data banks or on special request.

The fees charged for CDE's publications (for non-profit institutional investors) range from $60-75 for ownership directories to $5 a company for profiles from the data bank (with special profiles prepared at negotiated fees).

Corporate Data Exchange, Inc
198 Broadway, Room 706-7
New York, New York 10038
(212) 962-2980

5. Daniels & Cartwright, Inc.

Daniels & Cartwright, a Wall Street brokerage formed by two of the first black members of the New York Stock Exchange, sells research services that relate to the activities of major multinational companies in less-developed countries, especially in Africa.

The firm is a profit-making business, which sells its research reports primarily on a commission-dollar basis negotiated with individual investors.

Its reports include general studies on economic issues involved in U. S. business operations in the Third World, specific reports on individual companies, and reports relating directly to pending shareholder resolutions.

Daniels & Cartwright, Inc.
32 Broadway, Suite 1314
New York, New York 10004
(212) 425-8450

6. <u>Some examples of methods used by other investors to study the costs of divesting certain securities for social responsibility reasons</u>

Princeton Unviersity (1968)--Report of the Ad Hoc Committee on Princeton's Investments in Companies Operating in South Africa

Stanford Unviersity (1977)--Report by the Office of the Director of Finance on Exclusion of Investments in Securities of Corporations with Assets within the Republic of South Africa

Harvard University (1978)--Report of the Advisory Committee on Shareholder Responsibility with respect to South Africa Shareholder Reponsibility

These texts indicate the kinds of questions that must be addressed in a full examination of the costs and benefits of investor action for social responsibility. None of them discusses the benefits of action, nor does any of the reports consider possible actions other than divestiture. The Task Force intends no endorsement or criticism of these reports, but suggests that they might form a useful basis for development of appropriate analytical procedures.

Appendix C
Bibliography

ARTICLES

- Abouzeid, Kamal and Weaver, Charles. "Social Responsibility in the Corporate Goal Hierarchy." Business Horizons. June, 1978.

- Adams, Jerry. "The International South." The South Magazine. November, 1978, pp. 24-25.

- Belliveau, Nancy. "Searching for a Prudent Man." Institutional Investor, July, 1978, pp. 42-53.

- Berin, Barnet N. "From the Pony Express to the Pension Express." Across the Board, June, 1978, pp. 42-53.

- Califano, Joseph A., Jr. "U.S. Policy for the Aging - A Committment to Ourselves." National Journal, September 30, 1978, pp. 1575-1581.

- "Cash Management: The New Art of Wringing More Profit from Corporate Funds." Business Week, March 13, 1978, pp. 62-68.

- Chucker, Harold. "Pension Fund Study Proves a Bit Suspect." Minneapolis Star, September 17, 1979.

- "Clout to Become an Important Issue for Funds." Pensions and Investments, April 24, 1978, pp. 1-2.

- Comes, Frank. "Regional Development Bank: Credit Where Credit is Due." Empire State Report, October-November 1976, Vol. 2, Number 9, pp. 387-390.

- "Confrontation at the United Nations Pension Fund." Institutional Investor, March, 1977, pp. 274-277.

- Connelly, Julie. "Is Agressive Cash Management a Myth?" Institutional Investor, May, 1978, pp. 45-50.

- "Controversy Raised Over Investment of Pension Assets for Social Purposes Instead of Solely for Performance." Employee Benefit Plan Review, December, 1978, pp. 64-66.

- Cooper, John W. "The Basic Trends Which Are Emerging in Social Investing." Pensions & Investments, October 8, 1979, p. 33.

- Corcoran, Patrick J. "Inflation, Taxes, and Corporate Investment Incentives." Federal Reserve Bank of New York Quarterly Review, Autumn, 1977, pp. 1-10.

- Curley, N. "Dollar Drain?" The Milwaukee Journal, Tuesday, February 6, 1979.

- Dillon, Laura White. "Have U.S. Pension Funds Finally Discovered Foreign Securities?" Institutional Investor, August, 1978, pp. 107-118.

- "Do Institutional Investors Have A Social Responsibility?" Institutional Investor, March, 1977, p. 124, 126.

- Drucker, Peter F. "Pension Fund Socialism." Public Interest, Winter, 1976, pp. 1-47.

- Eaton, William J. "Unions May Seek Pension Investment Power." Los Angeles Times, September 20, 1978, part III, p. 17.

- Ehrbar, A.F. "Those Pension Plans Are Even Weaker Than You Think." Fortune, November. 1977, pp. 104-114.

- "Embattled Unions Strike Back at Management." Business Week, December 4, 1978, pp. 54-69.

- Gipson, James. "Losing Other People's Money Is A Very Serious Business." The Washington Post, January 7, 1979, p. 43.

- "How Pension Officers View Social Responsibility." Institutional Investor, April, 1979, p. 85, 86.

- "How Unions Invest Retirement Money." U.S. News and World Report, October 23, 1978, p. 99.

- Humble, John. "A Practical Approach To Social Responsibility." Management Review, 1978.

- Hutchinson, James D. "ERISA's Regulations and Fiduciary Responsibility: Keeping the Purpose in Mind," Textbook for Employee Benefit Plan Trustees, Administrators and Advisors. Volume 17, 1966, IFEBP, Milwaukee, Wisconsin.

- Hutchinson, James D. "Living With ERISA's Fiduciary Standards," Textbook for Employee Benefit Plan Trustees, Administrators and Advisors, Volume 18, 1977, IFEBP, Milwaukee, Wisconsin.

- "Institutions That Balk At Anti-Social Management." Business Week, January 19, 1974.

- "Investments: Pension Fund Assets Being Invested Against Interests of Workers, According to Study." BNA Pension Reporter, September 3, 1979.

- Janeway, Elliot. "Cash-Rich Companies Filling Banks Roles." Chicago Tribune, May 22, 1978, Section 6, p.10.

- Jenks, Alan. "Southern Firms Pitch for Investment." Atlanta Constitution, February 2, 1979, p. 14-D.

- Laurence, John F. "Use of Pension Power for Social Goals Can Backfire." Los Angeles Times, October 8, 1978, part 7, p. 3.

- Lyall, Susan. "Corporations Loaded With Cash." Dun's Review, January, 1978, pp. 54-55.

- Lynch, Mitchell C. "Paying the Piper; Soaring Pension Costs for Public Employees Plague States, Cities." The Wall Street Journal, May 5, 1978, pp. 1, 18.

- Maces, Michael, and Green, Robert. "Implementing Social Responsibility." NSU Business Topics, Winter, 1971.

- Macina, Marianne. "Wisconsin Looks At Socially Beneficial Investing." Pension World, May, 1979, pp. 25-27.

- Malkiel, Burton G. and Quandt, Richard E. "Moral Issues in Investment Policy." Harvard Business Review, March-April 1971, p. 37.

- Marcus, Bruce W. "Will Public Plans Sink The Cities?" Pension World, April, 1977, pp. 11-14.

- Minick, Clare. "Social Investing Sparks New York Fund Debate." Pensions & Investments, September 24, 1979, pp. 1, 33.

- "Money is There for the Capital Spending." Business Week, September 18, 1978, pp. 47-78.

- "More Unions Brandish Money as a Weapon." Business Week, February 26, 1979, pp. 47-78.

- "The Myth of the Southward Migration." The New Englander, December, 1978, pp. 61-62.

- O'Hara, Mary. "Pension Power Can Aid Unions." Pittsburgh Press, September 12, 1978, p. B2.

- O'Neal, Vincent. "Pensions, Politics and 'Prudent Man'." The New Englander, September, 1978, pp. 77, 79.

- Peirce, Neal R. and Hagstrom, Jerry. "Some New Remedies for Public Pension's Financial Ills." National Journal, November 26, 1977, pp. 1844-1849.

- Peirce, Neal R. and Hagstrom, Jerry. "Unions, Frostbelt Seek More Control Over Pension Fund Investments." National Journal, January 27, 1979, pp. 145-147.

- "Pension Power Unions Might Wield." Business Week, September 17, 1979, pp. 33-34.

- Phalon, Richard. "Personal Investing: Social Responsibility Investment Funds." New York Times, April 9, 1977.

- Pillsbury, Charles. "Union Pension Funds: Labor Becomes Capitalist." New Haven Advocate, October 25, 1978.

- "Prudence, Not Social Purposes, Must Control Investments." Employee Benefit Plan Review, April 1979, pp. 52-53.

- Rankin, Deborah. "Worrying About the Pension Gap." The New York Times, January 8, 1978, Section 12, p. 64.

- Raskin, A.H. "Labor and Investment of Pension Funds." The New York Times, November 9, 1977, p. 65.

- Raskin, A.H. "Show 'Em the Clenched Fist!" Forbes, October 2, 1978, pp. 31-32.

- "Retirement Policy: Certain Questions Must Be Answered Before Social Investments Can Be Debated, Woodruff Says." BNA Pension Reporter, March 28, 1979.

- "Revised Work Plan for an Economic Analysis of State and Local Pension Issues: The Impact of Alternative Policy Decisions." The Urban Institute. December 1, 1978.

- Rich, Spencer. "Union Fund Investments May Cost Frost Belt Jobs." Washington Post, July 23, 1979.

- Richman, Tom. "Ray Rogers Will Get You If You Don't Watch Out." The New Englander, September, 1978.

- "Rifkin,Barber, Pension Book: Socialistic Polemic." Pensions & Investments, September 11, 1978, p.8.

- Ross, Nancy L. "Financing Retirement: It's a Matter of Time." Washington Post, November 12, 1978, Section L, pp. 1-3.

- Ross, Nancy L. "Pension Funds Can't Ease Tight Mortgage Credit Situation." Washington Post, July 2, 1978, p. E3.

- Scherer, Ron. "Unions View Pension Cost as Leverage." Houston Post, December 30, 1978, p. 9-C.

- Schultze, Charles L. "The Public Use of Private Industries." The Brookings Institution. 1977.

- Scott, Maria Crawford. "Control Data Instructs Fund Managers to Use Socially Responsible Criteria." Pensions & Investments, August 13, 1979, pp. 1, 38.

- Scott, Maria Crawford. "Sacramento Funds Are Told To Divest South Africa Stock." Pensions & Investments, September 10, 1979, p. 31.

- Sheinkman, Jacob. "Union Role in the Boardroom." Employee Relations Law Journal, Summer, 1979, pp. 14-20.

- Smart, Donald A. "Investment in the Public Interest." Pension World, May, 1979, pp. 22-24.

- Smith, A.J.C. "The Forum." Dun's Review, February, 1978, pp. 85-86.

- "Social Investing Gains Backers; Critics Wary." Pensions & Investments, October 3, 1978, p. 39.

- "Social Investments or Responsible Investments? Georgetown Professor Sees A Difference." Employee Benefit Plan Review, August, 1979, p. 16.

- Social Responsibility in Pension Funds." Pensions & Investments, July 15, 1974.

- Stern, Les. "Drexel to Use Social Criteria to Invest." Pensions & Investments, September 10, 1979, pp. 1, 49.

- Stern, Les. "Senator Urges Investing for Social Goals." Pensions & Investments, October 9, 1978.

- Stern, Les. "Social Investing: A Volative Issue Surfaces." Pensions & Investments, October 23, 1978.

- Stern, Les. "Social Investing Permissible If Plan Beneficiaries Served." Pensions & Investments, February 12, 1979, p.2.

- Stern, Les. "Use of Assets Brings Divergent Opinions." Pensions & Investments, October 9, 1978.

- "Steven's Chairman is Forced Off Board by Union Pressure." Wall Street Journal, March 8, 1978.

- "Study Urges More Union Control Over Pension Fund Investments." BNA Current Developments, September 1, 1978.

- "Symposium Changing Perspectives for Pension Funds." Wisconsin Center for Public Policy, March 19-20, 1979, Madison, Wisconsin.

- Tassey, Gregory. "The Effectiveness of Venture Capital Markets in the U.S. Economy." Public Policy, Fall, 1977, pp. 479-497.

- Thackray, John. "The Nine Lives of Venture Capital." Institutional Investor, July, 1978, pp. 69-75.

- "Unfunded Pension Liabilities: A Growing Worry for Companies." Business Week, July 18, 1977, pp. 86-88.

- "Unions Flex Their Financial Muscle." U.S. News and World Report, October 23, 1978, p. 94.

- Wallace, Anise. "In Whose Best Interest?" Pensions and Investments, June 19, 1978.

- "Withers, et. al., vs. Teachers' Retirement System of New York." BNA, March 15, 1978.

- Witt, Matt. Review of Jeremy Rifkins' and Randy Barber's The North Will Rise Again, in The New Republic, September 16, 1978, pp. 22-23.

- Wyley, William, "Eat-up Firms' Profits." News-Journal, Wilmington, Delaware, February 13, 1979.

- Yohn, Frederick, Jr. "Recent Developments in Corporate Finance." Federal Reserve Bulletin, Volume 64, June, 1978, pp. 431-440.

BOOKS

- Blodgett, Richard. Conflicts of Interest: Union Pension Fund Asset Management. New York: The Twentieth Century Fund, 1977.

- Drucker, Peter F. Unseen Revolution: How Pension Fund Socialism Came To America. New York: Harper, 1976.

- Greenough, William C. and King, Francis P. Pension Funds and Public Policy. New York: Columbia University Press, 1976.

- Gujarati, Damodar. Pensions and New York City's Fiscal Crisis. Washington, D.C.: American Enterprise Institute for Public Policy Research, 1978.

- Harbrecht, Paul P. Pension Funds and Economic Power. New York: The Twentieth Century Fund, 1959.

- Kohlmeier, Louis M. Conflicts of Interest: State and Local Pension Fund Asset Management. New York: The Twentieth Century Fund, 1976.

- Marcus, Bruce W. The Prudent Man. New York: ESP Corporation/Pensions and Investments, 1978.

- Ott, David J., Ott, Attiat F., Maxwell, James A., and Aronson, Richard J. State-Local Finances in the Last Half of the 1970's. American Enterprise Institute for Public Policy Research, Washington, D.C. 1975.

- Pension Investments: A Social Audit, CDE Handbook. New York: Corporation Data Exchange, Inc., 1979.

- Rifkin, Jeremy and Barber, Randy. The North Will Rise Again: Pensions, Politics and Power in the 1980's. Boston: Beacon Press, 1978.

- Simon, John G. Ethical Investor: Universities and Corporate Responsibility. New Haven, Connecticut: Yale University Press, 1972.

- Treynor, Jack L., Regan, Patrick J., and Priest, William W., Jr. The Financial Reality of Pension Funding Under ERISA. Illinois: Dow Jones-Irwin, 1976.

- Vogel, David. Lobbying the Corporation: Citizen Challenges to Business Authority. New York: Basic Books, 1978.

DOCUMENTS

- Bearse, Peter J. (Ed). Mobilizing Capital for Economic Development: Institutional Innovation and the New Urban Policy. Princeton: Princeton University, The Center for New Jersey Affairs, August, 1978.

- Borjas, George J. Union Control of Pension Funds: Will the North Rise Again? Institute for Contemporary Studies, 1979.

- Curzan, Myron P., and Pelesh, Mark L. Social Responsibility Proxy Issues: The Role of Small Investors and the Power of Financial Institutions. Arnold & Porter, 1978.

- Kaufman, N. An Analysis of Current Issues and Pension Fund and Investment Practices. Northeast-Midwest Institute. Draft. April, 1979.

- Kittridge, Jack. Investing In Ourselves: Public Employee Pension Fund. Investment Strategies for Economic Impact and Social Responsibility. Report to the Task Force on Public Pension Investments (draft), Massachusetts Social and Economic Opportunity Council, Boston, Massachusetts, September 18, 1978.

- Kurz, Mordecai, and Arvin, Marcy. Current Issues of the U.S. Pension System. Draft, Chapter II, June, 1979.

- Large Corporate Pension Funds, 1979 Report to Participants. Greenwich Research Associates, 1979.

- Parker, Richard, and Taylor, Tasmin. Strategic Investment: An Alternative For Public Funds. Strategic Investment Advisors, 1979.

- Ravikoff, Ronald, and Curzan, Myron. Social Responsibility in Investment Policy and the Prudent Man Rule. Arnold & Porter, 1979.

- Rosen, Kenneth T. The Role of Pension Funds in Housing Finance, Joint Center for Urban Studies of the Massachusetts Institute of Technology & Harvard University, June, 1975.

- Taylor, Tasmin, and Parker, Richard. Strategic Investment: The Case For Increasing Total Yield on Wisconsin's Pension Fund. A Summary. Strategic Investment Advisors, 1979.

- U.S. Congress. House. Committee on Education and Labor. Pension Task Force Report on Public Employee Retirement Systems. 95th Congress, 2nd Session, Washington, D.C.: Government Printing Office, March 15, 1978.

- U.S. Congress. Senate. Subcommittee on Antitrust, Monopoly, Committee of the Judiciary. Beneficiary Participation in Private Pension Plans. Staff Report: 96th Congress, 1st Session. Washington, D.C. Government Printing Office, 1979.

- U.S. Department of Commerce. Economic Development Administration. Documenting the 'Decline' of the North. By C.L. Jusenius and L.C. Ledebur. Washington, D.C.: Economic Development Administration Research Reports, June, 1978.

- Task Force on Venture and Equity Capital for Small Businesses. Washington, D.C.: Small Business Administration, January, 1977.

- White, James J. (Chairman). Final Report of the Governor's Advisory Commission on the Regulation of Financial Institutions. State of Michigan, 1977.

TESTIMONY, SPEECHES

- Howell, Dr. James M. "The Northeast Means Business," Speech Given to the Boston Citizens Seminar, Boston: November 2, 1977, pp. 1-21.
- Hutchinson, James D. "Federal Prudent Man Rule Under ERISA." Remarks Before American Bar Association Annual Meeting, Atlanta: August 10, 1976.
- Kucinich, Dennis J. Speech Before the National Press Club, Washington, D.C.: September 28, 1978.
- Lanoff, Ian D. "Current Problems Under ERISA." Speech Given to the American Bar Association, 1977 Annual Meeting, Chicago: August 10, 1977, pp. 1-7.
- U.S. Congress. Senate. Committee on Human Resources. Hearings on S. 209, The ERISA Improvements Act of 1979. Additional Statement of the American Bankers Association, February 8, 1979, pp. 1-8.
- U.S. Congress. Senate. Committee on Human Resources. Hearings on S.209, The ERISA Improvements Act of 1979, Statement of the Association of Private Pension and Welfare Plans, February 7, 1979.
- U.S. Congress. Senate. Senator Metcalf Speaking on "Labor's Lost Votes and Voice." 95th Congress, 1st Session, October 26, 1977, Congressional Record, pp. E6570-E6580.
- U.S. Congress. Senate. Senator Nelson Speaking on "A Bill to Amend the Small Business Investment Act of 1958." S.1815, 95th Congress, 1st Session, June 30, 1977, Congressional Record, 123:114, pp. 1-4.
- U.S. Congress. Senate. Senator Williams Speaking on "A Bill to Amend the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1954." S. 209, 96th Congress, 1st Session, January 24, 1979, Congressional Record, pp. S557-S576.
- U.S. Congress. Senate. Subcommittee on Antitrust and Monopoly, Committee on the Judiciary. Hearing on Pension Fund investment Policy, 1979. Statement of Stephen J. Friedman, February 5, 1979, p.25.
- U.S. Congress. Senate. Subcommittee on Antitrust and Monopoly, Committee on the Judiciary. Hearing on Pension Fund Investment Policy, 1979. Statement of Ian Lanoff, February 5, 1979, p.2.
- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Opening statement of Senator Howard M. Metzenbaum, November 21, 1978, p. 1.
- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of Jerry D. Minton, November 22, 1978, P. 150.
- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of Jack Nicholl, November 21, 1978, p. 43.

- U.S. Congress. Senate. Subcommittee on Citizen and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of Jeffrey Friedman, November 21, 1978, p. 111.

- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of John W. Heilshorn, November 22, 1978, p. 227.

- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies., Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of Patricia Roach, November 22, 1978, p. 50.

- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of Roy A. Schotland, November 21, 1978, p. 4.

- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of Jacob Sheinkman, November 22, 1978, 9. 137.

- U.S. Congress. Senate. Subcommittee on Citizens and Shareholders Rights and Remedies, Committee on the Judiciary. Hearings on Pension Fund Investment Policies. Statement of Harrison V. Smith, November 22, 1978, p. 162.

Employee Benefit Research Institute

The Employee Benefit Research Institute (EBRI) was established in 1978 to contribute to the development of effective and responsible public policy in the field of employee benefits. EBRI is a tax exempt trade association with the overall goal of promoting the development of soundly conceived private and public employee benefit plans.

A non-profit organization, EBRI sponsors and conducts research in the employee benefit field. It publishes research results and other information on employee benefits, and sponsors lectures, forums, and workshops. By acting as an information clearinghouse, EBRI helps to provide private and public sector decision-makers with useful information.

The research sponsored by EBRI compliments the work done by others at universities, in govenment and in private institutions. By helping to avoid duplication of projects and by assisting in the compilation and dissemination of information, EBRI contributes to the orderly expansion of knowledge in the field. EBRI conducts most of its work through persons and organizations hired for specific projects.

The Employee Benefit Research Institute seeks a broad membership among companies and individuals that provide professional services in the employee benefit field, plan sponsors, and other interested individuals and organizations. A broadly based membership will help EBRI sponsor major research and educational activities. Dues paid to EBRI are deductible as ordinary business expenses by firms with a business interest in the employee benefits field.

EBRI has also established an Education and Research Fund. Contributions and Foundation grants to the Fund would be treated as charitable contributions.

More information on the Employee Benefit Research Institute can be obtained by writing: Executive Director, EBRI, 1800 M Street, NW, Washington, DC, 20036 (202) 659-0670.

EBRI

EMPLOYEE BENEFIT RESEARCH INSTITUTE
1800 M Street, NW/Washington, DC 20036

$10.00