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ECONOMICALLY TARGETED INVESTMENTS

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before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FOURTH CONGRESS

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CONTENTS

OPENING STATEMENT OF MEMBERS

WITNESSES

SUBMISSIONS FOR THE RECORD

ECONOMICALLY TARGETED INVESTMENTS

Thursday, May 18, 1995

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met at 9:37 a.m., Rayburn House Office Building, Room 2226, the Honorable Jim Saxton, Vice Chairman of the Committee, presiding.

Present: Senator Bingaman, and Representatives Saxton, Ewing, Manzullo, Sanford, Thornberry, and Stark.

Staff Present: Lawrence Hunter, Andrew Quinlan, Joe Engelhard, Andrea Tippett, Juanita Morgan, Colleen Healy, Lee Price, and William Buechner.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

Representative Saxton. The purpose of this hearing is to discuss the issue of Economically Targeted Investments, or ETIs. As Congress struggles to downsize government, President Clinton is working behind the scenes, apparently to expand government's reach, and use private pension funds to finance what we refer to here as his liberal social agenda.

In the investment world, this practice is known as "social investing." The Administration has dubbed these social projects as "Economically Targeted Investments," or ETIs, but others prefer to call them "Politically Targeted Investments."

Today, millions of hardworking Americans contribute significant sums of money to their pension plans. Each week they look at their pay stub to see how much money they have contributed to their pension fund. These millions of hard-working Americans expect their contributions to be there when they retire. They expect the pension trustees to invest their money with prudence and with loyalty.

Some years ago, Congress reacted to make sure this happened by passing a law, today known as the Employee Retirement Income Security Act (ERISA). The same is true with millions of retirees who rely each week on the pension check to provide them food, clothing and all the

necessities of life. These are issues that we often discuss here in the halls of Congress.

Last week, I introduced the Pension Plan Protection Act of 1995 to prevent the practice of ETIs, which was co-sponsored by our leadership on the Republican side and is expected to move through the House in a timely fashion.

It is important to note that something over $3.5 trillion are in private pension funds today. This is the amount of investment wealth that has been put at risk by the Clinton Administration in their advocacy of ETIs. It is well documented that the Administration has targeted private pension plans as a new way to finance their liberal social agenda.

Let me just quote directly from ERISA, so that no one can misunderstand the language that we are here to talk about, and the law which I have concluded is not being followed by the Administration.

The pension fund manager must, quote, "discharge his duties with respect to the plan solely in the interest of their beneficiaries and for the exclusive purpose of (I) providing benefits to participants and their beneficiaries; and (II) defraying reasonable expenses of administering the plan."

ERISA does not say, "fiduciaries must make decisions primarily in the interest of and almost entirely to provide benefits for participants and beneficiaries." It says solely and exclusively. Exactly what parts of "solely" and "exclusively" doesn't the Clinton Administration Labor Department understand?

And so I know that we will be joined here by people with different views of this. Olena Berg from the Administration is here to defend the Administration's position, and we will look forward to hearing her testimony and the testimony of others who are here to help us understand this issue in some detail.

I now turn to the Ranking Member, Mr. Stark, for his opening statement.

[The prepared statement of Representative Saxton appears in the Submissions for the Record.]

[The prepared statement of Senator Mack appears in the Submissions for the Record.]

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Well, thank you, Mr. Chairman. I regret to say that today's hearing is rather a waste of the Committee's time and energies. Many of us suspect, or know, why this hearing is being held.

Today, we are going to pass a Republican budget that will slash programs for America's elderly, for America's children, that will cut budgets for the Securities and Exchange Commission (SEC) and other groups who oversee and protect America's assets. The Republicans have slated the medicare portion of social security for a $288 billion cut and propose a $24 billion cut in social security checks. They plan to cut $187 billion in medicaid benefits, a third of which go to the elderly. And in combination, these cuts are going to cost the average elderly person more than $3,500 by the year 2002.

In a desperate, desperate attempt to change the subject, the Republicans are staging this hearing with the baseless charge that the Clinton Administration pension rules will hurt the elderly. In fact, just as in health care and social security, the Clinton Administration is working to defend and protect the elderly.

The policy to permit Economically Targeted Investments does not cost the elderly one red cent since the rules require that the risks and returns must be the same as for other investments.

I am familiar with the rules and I am familiar with the rules in California and in the State of New Jersey. I am sure the Chair is, as well.

The current interpretation of the law is identical to the policy adopted under previous Presidents, including President Reagan and President Bush.

The ERISA rules require that all investments, every single one, have competitive rates of return and risk, and they only permit the additional consideration of collateral benefits.

The legislation proposed by the distinguished gentleman from New Jersey is not just a solution in search of a non-problem, it is pernicious. It would bring "thought police" to Wall Street. If two pension fund managers make the same investment in a promising project that turns sour, the manager who can claim he only had financial considerations in mind has no problem. But woe betide the manager who may have invested not only for financial returns, but also for collateral benefits. He would be personally liable for losses under the Chairman's bill.

In effect, the Saxton bill says to fund managers, "Don't let us catch you considering anything that may benefit our country or your fellow citizens.

If we catch you thinking about anything but the fund's bottomline, you are in deep trouble."

What else does that bill say to pension managers? It says you can protect yourself by putting your funds in Wall Street, but don't put them in your own community. It says invest in multi-nationals that plan to close factories and ship jobs abroad, but don't even think about investing in an American company to help create jobs here in the United States. It says invest in a foreign company that will compete with the U.S. but don't think about using your funds to help American people compete.

Now, I would like to hear how this bill will deal with two programs in the State of New Jersey. In New Jersey, the State Investment Council directs the investment of about $34 billion in assets for the State public employees' pension funds. I believe those employees now work for a Republican governor. The following is a statement of the Council's policy towards social investing.

"The Council has adopted a favorable official policy requiring, quote, 'social investment.' The Council has determined that investing for the benefit of fund beneficiaries need not exclude investments in New Jersey or those which advance other social goals. In 1984, the Council codified a list of social investment rules for the State Division of Investment that includes reviewing all responsible investment proposals presented by New Jersey corporations and giving preference to New Jersey investments if other terms are equal."

Is the Vice Chairman going to go back to New Jersey this weekend and demand that the state pension funds be prohibited from giving preference to investments in his own State if other terms are equal?

There is another program the New Jersey Council initiated in 1986, and under the program, the Division determines a market rate for mortgages once a month and creates an open window to buy identical New Jersey mortgages from banks at this rate. In fiscal 1992, a million dollars of New Jersey mortgages were purchased.

If the Vice Chairman wishes to stop that, we will sell him California mortgages that -- New Jersey will never have it so good.

But the open window can prevent temporary capital gaps from developing if New Jersey suffers a shortage of secondary mortgage funds.

Now, I am sure that the distinguished Vice Chairman from New Jersey does not intend to shift New Jersey's pension funds to California. I am sure that, as we will hear from CalPERS and Ms. Berg, California can do a lot better job and we didn't invest in South Africa when apartheid was part of it.

There are many good things that can be done by investing in socially responsible opportunities, and they can be done, as we have experienced in this country for the past 20 years, while returning a reasonable investment and fulfilling the trustee's fiduciary responsibilities.

I suggest that this bill is overregulation. This is Washington run amuck where it is not needed. This is heavy-handed government interference, totalitarianism in the investment market where it certainly isn't needed. And I look forward to hearing from the witnesses this morning to hear their side of the story.

Thank you, Mr. Chairman.

[The prepared statement of Representative Stark appears in the Submissions for the Record.]

Representative Saxton. I thank the gentleman for his very articulate interpretation of what we obviously disagree very much on. And just for the record, it should be clear that our bill does not in any way affect public pension funds. It is geared toward private pension funds only, and so the gentleman's reference to New Jersey public pension funds has no relevance in this hearing.

We are joined this morning by Olena Berg, who is our single witness on the first panel. And I would just like to introduce her -- I am sorry, did the gentleman want to make a statement? Thank you.

At this time I would like to introduce Olena Berg, who is Assistant Secretary of the Pension and Welfare Benefits Administration. She is a graduate of the California State University and has an MBA from Harvard.

Ms. Berg.

PANEL I

STATEMENT OF OLENA BERG, ASSISTANT SECRETARY, DEPARTMENT OF LABOR, PENSION AND WELFARE BENEFITS ADMINISTRATION

Ms. Berg. Thank you, Mr. Chairman and Members of the Committee. I appreciate your inviting me to testify this morning. I would like to submit my formal testimony, with its attachments, for the record and summarize my remarks to leave time for any questions that you may have for me.

Now, I particularly appreciate the opportunity to be part of this inquiry this morning into economically targeted investing because I think that this hearing represents a much needed opportunity to move toward a shared understanding of the issues in this field. By the time you have concluded

your inquiry, I am confident that you will have dispelled a good deal of the misinformation that has been circulating on this topic.

Most importantly, I want to stress two things with you this morning. Number one, the Clinton Administration has no plans to mandate any form of pension investing, and secondly, we have absolutely no intention of taxing pension funds.

What we in the Clinton Administration are committed to is the protection of workers' financial security in retirement, as provided for in the Employee Retirement Income Security Act of 1974, or ERISA, the law governing pension plans. In fact, the Administration and Congress acted to strengthen the Federal protections for pension plans last year by signing into law the Retirement Protection Act. My primary mission as the Assistant Secretary of Labor for Pension and Welfare Benefits is to protect workers' pensions, and I would never advocate a policy that I believed would put pension plans at risk.

While many commentators may discuss Economically Targeted Invest-ments in terms of social goals, if you look at the speeches and comments that I have made on this subject, you will find that that is not why I talk about ETIs. My perspective is strictly that of someone who is concerned about the long-term viability of the pension system.

So why do I talk about ETIs and other long-term strategies? It is because we have to recognize that pension funds, with $4.8 trillion in assets, and growing, are an increasingly important force in the allocation of capital in the American economy. They are major investors in our nation's economy, and therefore they need to be concerned with its growth and its stability over the long term.

You will note that in our Interpretative Bulletin on this subject, we talk about ETIs as investments selected for the economic benefits they create, in addition to their investment returns.

Now, I think it is important to note too that pension plans are also a growing source of funds for investments in small business, an important source of job creation in this country. Further, as long-term investors, pension plans need to be concerned that capital is made available to these small businesses that will allow them to grow into the Fortune 500 companies of the future.

Mr. Chairman, last June, the Labor Department published its Interpretive Bulletin 94-1. This Bulletin summarized and reiterated the Department's long-held interpretation of Federal pension laws as they relate to ETIs. ETIs are generally defined as investments that not only provide appropriate risk-adjusted rates of return to the plan but also provide collateral benefits.

These benefits may include things such as job generation, affordable housing that allows workers to live near their places of employment, revitalization of infrastructure and small business development.

The Bulletin reminded readers that pension plans -- as, Mr. Chairman, you pointed out -- must invest for the exclusive benefit of the plan participants. It also repeated the long-standing position that it is consistent with ERISA for a pension plan fiduciary to select investments which provide other economic benefits, so long as these investments do offer a risk-adjusted rate of return comparable to alternative available invest-ments and also comply with all of ERISA's fiduciary requirements.

The Department has consistently stated to anyone who has inquired of us that pension plan fiduciaries may use their own discretion in determining how they will choose from among multiple investment opportunities that may be available to them. In the exercise of that discretion, of course, they must comply with ERISA's fiduciary standards.

Even before I came to Washington, the matter of ETIs was brought up and considered by the Department's Advisory Council on Employee Welfare and Pension Benefit Plans. This advisory body is a 15-member bipartisan group of nationally recognized pension experts. The 1992 Council, appointed by the Bush Administration, studied Economically Targeted Investments, took testimony for a year, and formally recommended that the Department "should issue an advisory opinion or other formal document affirming its current position on ETI programs."

Now, what did it say that that current position was back in 1992? The Council concluded that the Department, "should preserve the current ERISA interpretation which allows pension plans to favor ETIs once such assets meet a prevailing rate test based strictly on their financial characteristics."

I can't stress this enough. We have not changed the interpretation of the law one iota. And you needn't accept my word alone on this point.

Top Labor Department officials spanning the Presidents Reagan, Carter, and Bush have all taken the same position. I have attached to my testimony letters from two of them. However, because this major point needs to be made that the Clinton Administration has not changed the law or the interpretation of the law, I will quote from a few of my predecessors.

Ian Lanoff, from whom you will be hearing later, had my job in the Carter and beginning of the Reagan Administrations. Ian said, "The ERISA legal standards contained in Interpretive Bulletin 94-1, as they would apply to Economically Targeted Investments, are exactly the same as the ERISA legal standards which have been employed by the U.S.

Labor Department since the late 1970s when I served as ERISA Administrator at the Department."

Robert Monks, who served under President Reagan, quote: "Interpretive Bulletin 94-1 sets forth a policy that is consistent with the policies announced by DOL during the years that I had principal responsibility for the ERISA program."

Dennis Kass, who served under President Reagan, quote: "The view that non-economic benefits may be achieved incident to the proper investment of pension funds is one of long-standing under both the Internal Revenue Code prior to the passage of ERISA and under ERISA. Clearly, to prohibit such benefits where the provisions of law have been scrupulously adhered to would unnecessarily constrain fiduciaries in the exercise of their investment duties. Such a prohibition could result in specific investment opportunities being avoided by fiduciaries simply in order to avoid the possibility of an incidental benefit arising from them."

David Ball, my predecessor under the Bush Administration, quote: "It is the Department's long-standing position that...non-economic factors may only be considered in making investment decisions if they do not compromise the economic balance of risk and return to the plan and are consistent with ERISA's diversification and other requirements."

And finally, Marshall Breger, who was Solicitor of Labor under President Bush: "Nothing in ERISA's fiduciary provisions specifically prevents a pension plan from investing in infrastructure facilities [one type of ETI]. But like any other pension plan investment, it has to be done right."

All of these appointees, Carter, Reagan and Bush appointees, issued the same Labor Department position that we consolidated in Interpretive Bulletin 94-1.

Critics of economically targeted investing will often cite a handful of investments that turned out badly as evidence that ETIs are *per se* imprudent. But there are at least two independent studies that confirm the viability of ETIs as investment.

The General Accounting Office (GAO) recently reviewed hundreds of such individual investments by public sector plans and found that these plans earned reasonable financial returns through their ETI programs. Similarly, the Small Business Administration recently sponsored a comprehensive 50-state study of small business development ETIs. The study noted that ETI programs provide a source of capital for small business and concluded that ETIs provide rates of return comparable to similar investments.

In conclusion, we are committed to preserving ERISA's fiduciary standards and will oppose any tampering with those well-established and proven standards. This Administration does not, would not, and never will mandate the use of ETIs. Any suggestion to the contrary is simply wrong. We believe it is up to individual pension plans to find the investments that will earn the best risk-adjusted returns for each plan, and if those investments also generate benefits which help the economy, we think that is fine. After all, the financial strength of the pension system over the long run depends on a sound economy.

Thank you very much, and I would be happy to take your questions.

[The prepared statement of Ms. Berg appears in the Submissions for the Record.]

Representative Saxton. Well, thank you very much for a fine explanation of the Administration's current policy, and I have to say that I agree with much of what you have said about previous administrations and their tendency to grant permission to pension fund managers on various occasions when pension fund managers initiated on their own the desire to make an investment that could be called, under today's terms, ETIs.

I think where we have some difference of opinion, however, is that previous administrations, I do not believe, encouraged the practice of investing in ETIs such as this Administration does.

It is true, is it not, that you have done extensive travel around the country promoting the concept of ETIs? It is true, is it not, that today we have for the first time the establishment of a clearinghouse for the encouragement of ETIs? And it is true, and this is what troubles me a great deal, you say that there is no way that this Administration is ever going to mandate the practice of ETIs, however, it is very clear that in Arkansas law, during the time that President Clinton was the Governor of Arkansas, that the following language was included in Arkansas law.

It says, "it is the intention of the General Assembly and as assets become available for investment, the system shall seek to invest not less than 5 percent, nor more than 10 percent of their portfolio in Arkansas-related investments for economically targeted purposes."

That is the language which is in the law in Arkansas which President Clinton obviously signed into law while he was Governor there, and so we see here a trend on this Administration's part to encourage ETIs, to travel expensively, to spend fairly significant amounts of Federal money to encourage this practice, and that is certainly quite different from what we have seen in previous administrations. Would you not agree with what I just said?

Ms. Berg. Well, Mr. Saxton, there were probably several questions there and I will try and address each one of them individually. The first, if I understand, was you are differentiating us from previous administrations, even though the law has not changed, that we are encouraging ETIs.

One of the things pointed out by the ERISA Advisory Council, appointed by President Bush before I arrived and the reason for them asking that we make some sort of an affirmative statement in one place on the Department's position was that in spite of that long-held position, there seemed to be a substantial amount of confusion in the pension investment community about where the Department stood on ETIs.

There was evidence of this confusion from a study done by the Institute of Fiduciary Education that asked public plan sponsors (in this case) if they were investing in Economically Targeted Investments, and over half of those who said that they weren't, said that they believe that, *per se*, it was inconsistent with their fiduciary duty.

Now, as I have spent some time describing this morning, that is flat out not the case under ERISA. So we agreed that there was a need for the Department to put in one place what the position was. Very early on after I got here, representatives of some private funds, including those of several major corporations who were making these kinds of investments, reiterated they thought it was important that the law and the Department's position on the law be clear so that individual funds could make their investment decisions understanding what the law said on this issue.

That is what we have done. We have made it clear, and I have said this in every speech that I have given, that it is up to the individual plans to decide what are the best investments for them. We are trying to clarify what the law is.

And beyond that, as I pointed out in my testimony here, we think incidental benefits that are good for the economy in the long run are also good for pension plans.

Now secondly, I am not sure what is considered extensive travel. I have probably done a handful of trips out of town, but I will tell you, I don't typically call up people and ask them if I can come speak to them. If I am invited to speak and am able to do so, I do. And the first question we ask someone who invites me to speak is, what would you like to hear about? And then I try to talk about what people have asked to hear about. Therefore, where I have given speeches on ETIs, it is because I have been requested to do so.

Third, you mentioned the clearinghouse. We provided seed funding for a private, nonprofit entity to start up a clearinghouse with information on

this subject. That, again, was a recommendation made by the Bush Advisory Council when they studied economically targeted investing before I got here. The reason that they recommended a clearinghouse was the lack of information on this type of investment, and we all have to recognize that one of the costs of investing is obtaining information. And they concluded that one of the reasons plan sponsors might not be pursuing some of these investment opportunities is they simply did not understand them. And of course it is very important under ERISA, in order to be prudent, that you understand what you are investing in.

Not only the ERISA Advisory Council, but many other groups have suggested that having this kind of information available would be helpful to them.

Finally, with respect to the law in Arkansas, public funds are different than private funds in how they go about asset allocation, but it is not uncommon in public funds, as was the case in my State of California, for the legislature to essentially define broad asset categories that they would like their pension plans to be investing in.

For instance, in California, there is a required portion of assets that have to go to in-state mortgages. That is an asset allocation decision that the legislature, as overseer of the pension plan, I believe appropriately makes.

Representative Saxton. You don't deny that while President Clinton was Governor of Arkansas, that there was put in place a provision that mandated that between 5 and 10 percent of their portfolio be invested in Arkansas-related investments for ETI purposes?

Ms. Berg. I do not have the language in front of me, but my recollection is there was no mandate in the sense that it has to be exactly this amount. Rather, the language provides goals for in-state investment, so long as the purchase is otherwise prudent and they can find the opportunities, and again, as I stated, there are many public funds that invest pursuant to that kind of language.

Representative Saxton. It says exactly -- this language is very clear to me. It says, as assets become available for investment, the system shall seek to invest not less than 5 percent nor more than 10 percent of their portfolio in Arkansas-related investments.

Ms. Berg. I think the key words there are "seek to invest," and of course any asset allocation strategy by any pension plan is governed by other prudence considerations. In the case of the pension funds that I have been involved in, they have set aside for example, money for venture capital, and for several years may not be able to get up to that benchmark

amount because they don't find sufficient investments. Those are asset allocation targets.

Representative Saxton. Tell me about the clearinghouse. Is it currently operating?

Ms. Berg. It is currently in the process of becoming operative would be the best way to describe it. They have completed the process for OMB clearance of the survey that they will send out to collect data, which took some time. They are developing their infrastructure, if you will, the database, and are putting together their advisory board and doing those sorts of things.

Representative Saxton. Would this clearinghouse seek to have between 5 and 10 percent of private pension funds invested in Economically Targeted Investments?

Ms. Berg. The clearinghouse serves strictly an informational function. They will be surveying pension plans who may already have done this kind of investing to get information on the investments that they have already made. They won't be involved at all in pension plans investment policies.

Representative Saxton. You mentioned that you had made a handful of speeches about ETIs. I think at our request, you have sent us 11 speeches that you have made. Can you tell us whether that is all the speeches that you have made or whether there were additional speeches that you have made on ETIs?

Ms. Berg. The 11 speeches sent and the handful -- I apologize. A handful of those 11 were given out of town, and the rest of them were in Washington. I don't remember the exact distribution. We went back through, at your request, the speeches that I have given. Those 11 were the ones that were specifically directed toward ETIs.

I have also given some speeches where people have asked for me to review the major things going on in the Department of Labor, and I may have mentioned ETIs as one of any number of things.

Representative Saxton. Do you have any idea how many times you have spoken on ETIs?

Ms. Berg. Well, again, the list that I gave you were the speeches that were specifically addressing ETIs.

Representative Saxton. The cover letter said they were selected speeches on ETIs and that is why I was curious to know whether there had been others.

Ms. Berg. We were trying to respond to the request. We gave you all the ones where the speech was specifically on ETIs and we said selected

because, again, I certainly have mentioned ETIs in much more general speeches about many activities going on in the Department.

Representative Saxton. Ms. Berg, prior to 1974, generally accepted practices with regard to private pension funds were that they would be invested for the benefit of the beneficiaries in the plan without regard to other social benefits that might accrue, kind of a general attitude that pension fund managers and regulators had.

Then in 1974, Congress passed the law that is today known as ERISA, and the language in ERISA codified what had been the general practice, and that was, and let me quote the language, "the duties of the pension manager are to discharge his" -- and I think we might say or hear today -- "duties with respect to a plan solely in the interest of their beneficiaries and for the exclusive purpose of, one, providing benefits to participants and their beneficiaries, and two, defraying reasonable expenses of administering the plan."

With that language in place, it had also been the practice of pension fund managers on occasion to come to seek relief from that language, as I understand it, from the Secretary of Labor when they had a desire to invest in some other plan.

Is it not true that the initiative of this Administration is to encourage this practice more so than previous administrations and thereby encourage more investments that would take place, or that are taking place above and beyond the stated purposes in the law?

Ms. Berg. As I mentioned previously, our intention has been to make it clear what the law is, and that the law has not changed through that history --

Representative Saxton. If I may say so, I have a tough time understanding why it is that this law needs to be made more clear because it is stated as explicitly as anyone could ever state what the objectives of the pension fund manager would be, to provide benefits to participants and their beneficiaries and to defray reasonable expenses. I don't have any trouble at all understanding that language.

Ms. Berg. Mr. Chairman, many people have come to us, and you have, as an attachment to what I have submitted 23 letters where people have read exactly that language and asked, we have an investment that we want to make and it provides an incident benefit to someone else, are we running afoul of that language?

And in 23 letters, the Department has said, over 15 years, exactly the same thing: As long as you don't sacrifice returns or increase risk, it is perfectly appropriate for you to consider those incident benefits.

That is exactly what we addressed in the Interpretive Bulletin as well and that is where the confusion seems to come about.

Representative Saxton. I think where the confusion comes about is that we see a track record here of encouraging a practice which by definition has to increase risk in the plans, has to, in my opinion, increase risk in the plan.

Number two, we see a President who was formerly the Governor, who signed at least and perhaps promoted the notion of having a quota of 5 to 10 percent, and an increase in activity in promoting on your part, your job, and you are doing what -- you are setting out to accomplish what you think is right and that is fine.

But we see a pattern here of a change in pension fund investing that concerns us very much, and I just think that you should be aware, and I know you are, because we have had communication written and otherwise previously, and we have even shared the same podium in addressing this subject in Washington in different forums, but you should be aware that there is a great deal of concern on the part of this leadership in the House of Representatives, and this is a pattern which we don't think is healthy.

And so we share your enthusiasm for making sure that we invest this money as prudently as possible, but I am not sure -- in fact, I am sure that we don't share your enthusiasm for Economically Targeted Investments.

So I will stop at this point and yield to the Ranking Member for his contribution here.

Representative Stark. Ms. Berg, I am sure you are familiar with the quotation that probably started all this: "Bring the full tithes into the storehouse, that there may be food in My house, and thereby put me to the test, said the Lord of hosts, if I will not open the windows of heaven for you and pour down for you an overflowing blessing," Malachi 3:10.

This started a long time ago, you know, and now Congressman Saxton wants to end it all. We are going to have to rewrite every Gideon Bible, but only for this assemblage, their great assemblage of right wingers here from the CATO Institute and the Olin Institute, people who never had a job except the guys who funded this, and who mostly inherited their money.

But I want to find out what this Administration is up to now. Have you been, more so than the previous two administrations, discouraging teen-age pregnancy? Have you been discouraging drinking before driving? Have you been discouraging smoking by pregnant women? Have you been encouraging patriotism and abstinence from drugs?

Haven't you done a far better job and hasn't this Administration traveled far and wide to spread that word to the American public?

Ms. Berg. Well, certainly I would say that all of us who represent the Clinton Administration believe that it is part of our jobs to talk about our policies.

Representative Stark. But the President does, doesn't he?

Ms. Berg. Certainly.

Representative Stark. He believes that firmly.

Now, do you see anything wrong with encouraging people to do the right thing in their everyday lives?

Ms. Berg. No.

Representative Stark. Now, is there anything, is there any scintilla, is there any sentence, is there any requirement, is there any passage, is there any regulation, law, or anything like that, that requires affirmative action on ETIs on the part of any pension manager, public or private, in the Federal government?

Ms. Berg. No, Congressman Stark. In the language which you are putting it, I would summarize the position: If you, as an investment manager, conclude that there is an investment that is otherwise equal in its return and reward characteristics and it does something that you consider good --

Representative Stark. But I don't have to do that.

Ms. Berg. It is all right for you to do if you want to.

Representative Stark. I can buy tobacco stocks and kill people, right?

Ms. Berg. If you want to.

Representative Stark. That is what I am saying. There is no restriction, absolutely none, until my good friend from New Jersey came along and decided we ought to clamp down on these brilliant investment managers and prevent them from exercising their free market right.

Is it not within the definition of the fiduciary responsibility of a trustee, isn't it, in a democracy, isn't it a God-given right for them to choose among any investment that is legal in this country?

Ms. Berg. As long as it is otherwise prudent.

Representative Stark. Wouldn't it sound a little bit totalitarian to restrict the choice in a free market economy of investment managers from picking investments that otherwise meet the tests of a prudent man?

Ms. Berg. It is our view that ERISA has worked very well in allowing plans to pick among all alternative instruments available to them and no restriction is necessary.

Representative Stark. You are familiar, Ms. Berg, I know, with secondary markets. Isn't it true that the President had just established a plan to encourage secondary markets in investments in small businesses to improve the liquidity of lenders, formerly like myself, who used to make it a policy never to turn down any small business loan -- there aren't many banks that have that record I might add -- but to improve the liquidity of bankers who would do the right thing? The President has encouraged a secondary market for the securitization of small business loans to help small businesses have access to capital.

Now, do you think that the restrictions such as Congressman Saxton has suggested might have a dampening effect on the creation of that secondary market?

Ms. Berg. We think it could well have a dampening effect on anyone who might be thinking about making such investments if they were worried about being open to the charge that they had done it for the incidental benefits, yes.

Representative Stark. So in effect, if I were back running my old bank, I would probably be nervous for fear that the thought of police, engendered by Mr. Saxton's bill, would come after me if I made loans to small businesses and it would be much simpler just to keep buying Treasury bonds and Fannie Mae insured mortgages, correct?

Ms. Berg. If, under the terms of the bill, your bank was an investment manager for a pension plan, certainly.

Representative Stark. Well, I certainly hope that we don't encourage the creation of "thought police" on Wall Street. It wouldn't have a lot to do, but it ought to scare the people who are there.

Thank you, Mr. Chairman.

Representative Saxton. Thank you, Mr. Ranking Member. I appreciate your sense of humor. I hope the people who invest in private pension funds share your glee on this subject.

I yield at this point to the gentleman from South Carolina, Mr. Sanford.

OPENING STATEMENT OF REPRESENTATIVE MARK SANFORD

Representative Sanford. What I am hearing, both through, I guess in Malachi, encouraging people to do the right thing, is really a philosophical question we are struggling with more than anything else.

Representative Stark. There is no law.

Representative Sanford. Philosophical difference, and that is, if you look at pensions and the dollars that they represent, I think the question we have to ask ourselves in terms of asset allocation -- you spoke earlier of California and how the State legislature there had decided that California pension benefits to some degree would invest in home mortgages, that they thought that was good public policy.

But I think that what we have to ask is who ultimately is the best manager of money? And if we think that the political body here in Washington is the best manager of money, then we maybe ought to pursue ETIs. Maybe they make sense.

But what I have seen over the last couple years is -- I mean, you look at the $4.8 trillion debt. You look at structuring $250 billion deficits. I would argue that we are not that good at allocating assets, and, in fact, we probably lead to distorted decisions in terms of good management of money.

So if I was to draw a hierarchy, I would say politicians are probably at the bottom of the barrel in terms of managing money. Governor administrators are somewhere midstream, and I think that individuals who themselves are ultimately tied to that money when they produce are the best managers of money, and that this question is larger than anything else philosophical and that don't we think that the individual themselves would be the best manager in their hometown to decide what should be targeted socially or economically? What would your thoughts be on that?

Ms. Berg. Congressman, we are now talking about investments in the context of trust law and ERISA where fiduciaries are making those investment decisions on behalf of individuals. It is not individuals themselves making the decisions. The money for workers' future pensions has been collected, and I would agree that law right now allows those pension fund managers, to make that decision. We therefore think any restriction on that ability is unnecessary. Right now, it is the investment managers who decide among the various alternatives that are available to them what is most appropriate for their individual plan.

Representative Sanford. But at the core, ETI is going to do that, as I understand.

Ms. Berg. Well, I think there has been some fundamental misunderstanding. An ETI inherently is no more or less risky than any other kind of investment. They are all over the investment continuum. Just to give --

Representative Sanford. Although, it is my understanding that Wayne Marr would disagree. His finding was that on a basis point return of 110 to a 320 point spread in terms of greater return with ETIs.

Ms. Berg. Well, that study --

Representative Sanford. You would say he is wrong?

Ms. Berg. We have some severe methodological concerns about the study because it never actually looked at the returns of the ETIs. It looked at plans that might be making these kinds of investments and said that their returns are different from other plans. But they did not adequately control for risk.

To give you an example, the differing rate of return might well be because they were much more heavily invested in commercial real estate that happened to go bad at that time or they might have been in the Japanese stock market. There is nothing that connects those returns to economically targeted investing and, in fact, because most plans that do this kind of investing do it in such small dollar amounts, there is no way that they could have those kinds of effects on the plan returns.

Also, these studies have looked over a very short period of time. It would be like my looking last year and saying, well, gee -- or whenever this last happened, the bond market out-performed the stock market this year so we shouldn't invest in stocks. And in fact, the one study that did go over five years found that difference disappeared.

Representative Saxton. Mr. Thornberry.

OPENING STATEMENT OF REPRESENTATIVE MAC THORNBERRY

Representative Thornberry. Not at this time, Mr. Chairman. I guess we need to go vote.

Representative Saxton. Thank you very much.

Mr. Ewing, do you have questions for Ms. Berg?

OPENING STATEMENT OF REPRESENTATIVE THOMAS EWING

Representative Ewing. Are there any directions that you have from the Administration on what your policy should be in encouraging the managers to make investments maybe along the line of what we are

talking about here? Do you make that policy? Does it come from the White House?

Ms. Berg. Well, the policy that I presented here today with respect to a legal position on economically targeted investing, the fact that we have no interest in mandating any kind of investment practice, and that we are not proposing taxing pension funds, are all the policies of the Administration, as well as my policies.

Representative Ewing. Well, when the President was Governor of Arkansas, he did have a different policy. I mean, he signed legislation down there that did encourage a percentage to be invested in Economically Targeted Investments. Do you -- are you saying that has never been discussed in this Administration?

Ms. Berg. Certainly, economically targeted investing has been discussed. I have sent copies of my speeches over to the Committee. I am here discussing it today. The major policy, if you want -- the single policy pronouncement is that we want to make clear what the law is.

We want to say that ERISA permits ETIs to the extent that investments can be made that provide good returns to pension plans, don't sacrifice returns or increase risk, and also benefit the economy. We think it is terrifically important to benefit the economy. Finally, we are not interested in mandating anything to anyone.

Representative Ewing. Well, if you say it has been discussed and if Economically Targeted Investments, are totally sound, why do we even have this as a subject matter?

Ms. Berg. Well, again, as I pointed out with the --

Representative Ewing. I would think they would be fighting for them.

Ms. Berg. As I pointed out with the 23 individual letter requests that we have issued, with the survey of the Institute for Fiduciary Education, with the results of the year that the ERISA Advisory Council in the Bush Administration spent studying this subject, there was confusion around the issue. As a result, no matter how good the returns may have been, there were investment managers who were afraid that, *per se*, they couldn't make an investment if it had these other benefits.

That is absolutely not what the law says. What we have tried to do is to clear up that misunderstanding of the law.

Representative Ewing. You don't feel that there has been any subtle pressure put on managers then to try and find Economically Targeted Investments?

Ms. Berg. Absolutely not. For instance, there is no way in the reporting that pension plans do to us that we could distinguish an ETI from any other kind of investment, because ETIs are made in the form of equity investments, debt instruments, and other sorts of things. We would have no way of knowing whether a particular investment was an ETI or not, nor would we ever ask an individual plan manager.

What we are interested in is whether or not investments are made prudently, no matter what kind of investment it is. That is what we look to.

Representative Ewing. So that is your bottom line?

Ms. Berg. Absolutely.

Representative Ewing. Prudence?

Ms. Berg. Prudence.

Representative Ewing. Prudence. Thank you.

Representative Saxton. We are going to have to break and go ahead and vote, but we want to thank you for being here this morning and we could, I am sure, discuss this issue with you for quite awhile. We have several other panels of people who are here to also discuss this with us.

We are going to break. We should be back here in 10 or 15 minutes after this vote.

Ms. Berg, thank you very much for being with us. We appreciate it very much.

Ms. Berg. Thank you, Mr. Chairman, Members of the Committee.

[Recess.]

Representative Saxton. Thank you for your patience.

I would like to at this point introduce our second panel. John Langbein has served as the Chancellor of Kent, Professor of Law and Legal History at Yale since 1990. His particular area of focus is pension and employee benefit law. He is an active member of the American Bar Association, Selden Society, and the U.S. Secretary of State's Advisory Committee on Private International Law.

Mr. Langbein has been published numerous times on the issue that we are discussing today. Among his articles are, "The Conundrum of Fiduciary Investing Under ERISA" and "Proxy Voting of Pension Plan Equity Securities, "Social Investing of Pension Funds and University Endowments: Unprincipled, Futile and Illegal", and of course there are a long list of others that I won't mention.

Also here to testify with us is Charles Rounds, a graduate of Columbia University and professor of law at Suffolk University Law School, he has an active consulting practice in trust matters and is counsel of the Franklin

Foundation, a 200-year old trust established under the will of Benjamin Franklin. In addition, he is a noted author, co-author of the seventh edition of *Loring: A Trustee's Handbook.*

And also Ian Lanoff, an attorney specializing in special law, former Assistant Secretary in the Labor Department during the Carter Administration. I welcome you all, and I understand that Mr. Rounds will be our first person here to testify.

If I might just remind you that because of time constraints, we are forced here oftentimes -- and today is no exception -- to operate under what we call a five-minute rule. These little bulbs here in front of me will light up. The green one means go. The red one means stop. And so at the five-minute mark, the red light will remind you that your time has expired. Of course we will make your entire statement part of the official record.

So, Mr. Rounds, if you would begin.

PANEL II

STATEMENT OF CHARLES E. ROUNDS, JR., PROFESSOR OF LAW, SUFFOLK UNIVERSITY LAW SCHOOL

Mr. Rounds. Thank you, Mr. Chairman.

Mr. Chairman, Members of the Committee, my name is Charles E. Rounds, Jr. I am a professor of law at Suffolk University Law School in Boston and co-author of the seventh edition of *Loring: A Trustee's Handbook.* The *handbook* will have its 100th anniversary in 1998.

I am pleased to testify in opposition to the Clinton Administration's policy of encouraging private employee benefit fund managers to invest in Economically Targeted Investments. I wish to make, please, one fundamental point: Secretary Reich's ETI policy interferes with the private property rights of working Americans by undermining the fundamental duty of trustees to act solely in the interest of their beneficiaries.

Since 1976, the common law trust has been the focus of my teaching, writing and practice. Professor Maitland considered the trust -- a refinement in the concept of private property -- to be the greatest achievement of English jurisprudence. So do I.

It is because I am convinced that a number of initiatives of the Clinton Administration, the Clinton Deficit Reduction Trust Fund, the Violent Crime Reduction Trust Fund, the Presidential Legal Expense Trust, and perhaps most troublesome of all, Secretary Reich's ERISA Regulatory Bulletin encouraging private fund managers to invest in ETIs, assaults the very institution of the private trust that I come before you today.

There are real world consequences to all of this that extend beyond the ivory tower. In the case of Secretary Reich's ETI policy, for example, the undermining of a trustee's fundamental duty of loyalty threatens not only the institution of the trust, but the nest eggs of millions of working Americans, the life savings of real people.

A trust is a fiduciary relationship with respect to property. The trustee has the title to the property. The trustee, however, has a duty to deal with the property for the benefit of another. In trust parlance, that other person is called the beneficiary.

With the exception of insured plans, the assets of private employee benefit plans are held in private common law trusts. Thus, the worker who participates in a private qualified employee benefit plan is a trust beneficiary. As such, under the common law, and under ERISA, he is entitled to the trustee's undivided loyalty. Secretary Reich's ETI policy erodes that fundamental duty. The restatement of trusts is unambiguous in this regard.

In administering the trust, the trustee is under a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust. Thus, it is improper for the trustee to purchase property for the trust for the purpose of advancing an objective other than the purposes of the trust.

It is settled law that a worker's interest in a private employee benefit trust is an item of private property. It belongs to the worker, not to the trustee, not to the employer, not to the taxpayer, not to Secretary Reich, not to President Clinton, not to the members of this Committee. It belongs to the worker. When Secretary Reich plays with a trustee's fundamental duty of loyalty, he is playing with the personal assets of workers and their families.

Moreover, this aggregation of private wealth has a difficult enough and important enough social mission, namely, to provide private economic support to those workers and those families, in other words, to real human beings. It does not need the additional burden of having to participate in Secretary Reich's risky social experiments.

Suffice it to say that to the extent economic value actually gets sucked out of our private pension system as a result of public political initiatives such as ETIs, someone will have to absorb the resulting economic loss to the extent it cannot be taken out of the hides of the trustee, be it the worker, the employer's stockholder, or the taxpayer. Wealth does not exist in a vacuum.

This concludes my opening remarks.

[The prepared statement of Mr. Rounds appears in the Submissions for the Record.]

Representative Saxton. Thank you very much. Mr. Langbein.

STATEMENT OF JOHN LANGBEIN, CHANCELLOR KENT, PROFESSOR OF LAW AND LEGAL HISTORY, YALE LAW SCHOOL

Mr. Langbein. Thank you, Mr. Chairman, Members of the Committee. I appreciate the opportunity to be with you. I have a prepared statement. I just want to hit a couple of the highs and then I would be glad to take questions.

Let me begin by saying that it is very important to understand that most of the really troublesome social investing problems, the ETI initiatives, are not in the ERISA covered area. They are in state and local plans, which are exempt under ERISA 4(b) and they are in university and eleemosynary endowments. That is where the real trouble is, and, in that sense, ERISA has been a real success story.

The provisions of ERISA that we have talked about and that the Chair has quoted today -- ERISA's exclusive benefit rule and duties of prudence -- those standards have been so powerful that the Labor Department has rightly interpreted them to eliminate most of the abuse. I still think that some measure of the sort that is being proposed here today is important and useful, but it is very important as background to be aware that most of the worst of the abuses are in the state and local plans.

The scandal that we have in Connecticut, my home State, with the State Treasurer buying the Colt Gun Factory in effect or the terrible disasters of the Kansas plan had where they wound up buying everything from video stores to synthetic fuel manufacturers and so forth, trying to create jobs in Kansas and wound up with a loss of $100 to $200 million, that kind of stuff is just outrageous and is stopped now under ERISA.

So we start with an understanding that ERISA has done a tremendous job. So what is left to do? Why are we here? Why are we worried?

Well, the answer is that ERISA still leaves open an opportunity for some mischief of the sort that you are rightly worried to prevent, and that comes about because of the so-called costlessness standard that is used to decide whether or not these politically motivated investments can be made. The rubric which you heard Secretary Berg, Assistant Secretary Berg referring to this morning is essentially that. It is okay to be politically conscious and politically motivated as long as you have a comparable economic return and, therefore, the social side of your investment is, quote, "costless."

This formulation originated back in the 1970s under Ian Lanoff here when he had that job over at the Labor Department, and it was, I think, probably a pretty good first stab at trying to get rid of the worst of the offensive social investing forms, but it allows a lot of mischief, and I have talked about that in the prepared statement that I have submitted to you today.

The problem is that costlessness is just too easy to fudge, that we can't find out what the costs are. These costs are hidden. Remember that we are not looking at things with market prices. If you pay more for AT&T stock than the guy next door to you is paying for AT&T stock today, we will find out in effect, and the costlessness rubric will stop you. It is illegal and we can prevent it.

But that is not what we are talking about. We are not talking about investments that have a market price. We are talking almost by definition in this social investing universe about one shot deals, about investing in particular mortgage schemes, particular real estate developments, particular closed corporations, and the thing that all those investments share in common is that you can't look up in the *Wall Street Journal* or *Barrons* and find out the market price and, therefore, it is just about impossible to police the costlessness standard.

These investments lack that comparability that is needed to demonstrate that the investment was indeed costly or not costly to the pension fund.

It is that problem that would lead me to encourage you to go somewhere down the line that you are going in the legislation that is proposed, the effort to try to insist that we close off these noneconomic activities.

What happens in the present situation is that a politically motivated investor can just paper the file, he recites that he has looked around, he recites that he has looked around for the best possible return and that this particular politically motivated investment has got it, and at that point it really is just impossible for the enforcement people to come along and unpack him. If you compare that with what we do in trust law, by the way, pure trust law, we have an opposite rule. That is the rule that really works and that I recommend to you.

In private trust law, we have an absolute duty of loyalty and that duty of loyalty is one that says, you may not take into account anything other than the beneficiary's interest, and if you do, you are absolutely liable. We don't want to hear about reasonableness or fairness and that is of course what this costlessness stuff is. It is just another word for reasonableness or fairness. You are liable.

And because we have that standard, we don't have these problems over in the world of private trusts. I think that the same idea should apply to social investing, the same rationale, to ETIs, social investing schemes. They are by definition disloyal. When you set out to take into account the benefits of others, other than the worker, you are by definition imperiling the interests of the people to whom you owe that duty of loyalty.

Thank you.

[The prepared statement of Mr. Langbein appears in the Submissions for the Record.]

Representative Saxton. Thank you very much. Mr. Lanoff.

STATEMENT OF IAN LANOFF, ESQ., BREDHOFF & KAISER

Mr. Lanoff. Mr. Chairman, Members of the Committee, thank you for inviting me here this morning. Unlike my distinguished colleagues up here, I am not a law professor. I am a practicing lawyer. I don't know if that is an advantage or a disadvantage.

I represent -- since leaving the Labor Department in 1981, I have had several clients in the corporate -- Taft-Hartley -- and public plan community. I currently am outside fiduciary counsel to the California State Teachers Fund, a $60 billion public pension fund. I am outside counsel to the Massachusetts State Pension Fund, which is a $30 billion public pension fund. I also represent the Mine Workers Funds, Musicians Funds, the Bakery Workers Funds. With respect to all of these, I work with the rules that we are talking about every day of the week. That is basically what my practice has been in the 14 years since I left the Labor Department.

I would like to make a few points without, of course, reading my testimony.

First of all, I believe that the rules that the Labor Department have reiterated, which are rules that my Labor Department promulgated and which other Labor Departments have followed slavishly through these years, are rules that have been applied with success by the respective administrations.

The Department of Labor has stopped abuses in the private sector, and to a large extent, because of the interpretation of these fiduciary principles by the Federal government, even in the public plan area, I think we have been successful in stopping abuses there as well, even though the law doesn't literally apply to the decision-making of those fiduciaries.

The Administration, as you heard me quoted, in my view, has not weakened the standards, and in support of that, I would like to simply point to the Model Uniform Prudent Investor Act, which has been ap-

proved by the National Conference of Commissioners of Uniform State Laws.

Professor Langbein is a committee member, and I call your attention to the October 24th, 1994 Pension Reporter, where that Uniform Act is contained, to a comment that states the following:

"In 1994, the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA, citing the Interpretive Bulletin. The Bulletin reminds fiduciary investors that they are prohibited from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives."

And I don't think you could state it any clearer than is stated there.

In my testimony, I review the law. In a nutshell, prudence and loyalty in ERISA permit the consideration of noneconomic factors so long as those noneconomic factors are not inconsistent with the economic analysis that trustees must go through under the prudence and loyalty standards before making their investment decisions.

And Professor Langbein is correct. In 1980, we devised what has been described as the everything-being-equal test, which states the rule that if trustee fiduciaries are going to be making investments where noneconomic factors are taken into account, those noneconomic factors can only be taken into account if the economic criteria that they use in selecting the investment are equivalent to comparable investments that those trustees might consider in reaching their investment decision.

Probably the best statement of this rule is contained in the *Donovan* v. *Bierwith* case, which I cite in my testimony. The opinion was written by the very famous Judge Friendly, who I don't think any lawyer in this country would consider to be a liberal judge, and what he wrote in that opinion is: "Trustees of a pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote the interests of the participants and beneficiary simply because it incidentally benefits the corporation or indeed themselves."

So as long as the benefit is incidental to the fundamental underlying economic criteria that the fiduciaries rely upon, it is totally consistent with ERISA; and I would submit, with trust law which ERISA is based upon.

Now, some ETI investments are risky and others are not, just like any other investment and in 1978, when I was at the Labor Department, we issued what is called the Prudent Investor Rule, or the Prudence Rule.

That rule made it clear that under certain circumstances, it is perfectly appropriate for fiduciaries to take risks with the assets that they invest on behalf of participants and beneficiaries.

Why did we issue that rule? It seems self-evident that you could take risks and make investments, especially if you are sophisticated. The reason was that many investors, including so-called "sophisticated" investment managers, were not investing in very attractive investments, such as venture capital and real estate, because they were afraid that ERISA banned investments in anything that was riskier than stocks and bonds.

I was told by several people that it is foolish to issue this Prudence Rule. Once we issued the Prudence Rule -- as you may know if you followed pension investments, pension funds, both private and public -- we began investing in both venture capital and real estate, and for the most part, particularly with venture capital, have had phenomenal returns.

I would submit that the bulletin that the Labor Department recently issued was aimed at the very same objective. For whatever reason, sophisticated investors who might otherwise be interested in investing in ETIs, particularly in a new product called infrastructure, were afraid to invest in ETIs for the very same false reasons that people back in the 1970s, sophisticated investors, were afraid of investing in venture capital and real estate.

And I would submit that, as a result of this interpretive bulletin, fiduciaries will do the very same thing fiduciaries did with respect to venture capital and real estate. They will go out, hire very sophisticated experts, they will rely on those experts and instead of having, as Professor Langbein suggests, political objectives serve as the basis for their investments, they will rely on these experts just as the fiduciaries of plans have since 1978 for venture capital and real estate.

Those experts' only incentive is for those investments to be successful. They are not interested in political motives. They are not interested in social motives, and they don't let the fiduciaries get away with introducing noneconomic criteria into their investment decision-making.

[The information submitted by Mr. Lanoff appears in the Submissions for the Record.]

Representative Saxton. Thank you, Mr. Lanoff. Let me just ask one quick question, and then I will turn to my colleagues.

Mr. Langbein, Mr. Lanoff just referred to a test that he referred to as the "everything-being-equal test." Can you comment on that? What is your impression or your opinion of the fact that, golly gee, we might as

well make these other investments and do some other good because after all, everything is equal?

Mr. Langbein. It is interesting that the language that Ian Lanoff just read from the Uniform Prudent Investor Act is language that I, in fact, drafted. I was the reporter for that, and I am the author of the comment that he was reading. That comment refers to the portions of the Interpretative Bulletin that indeed are congruent with a very strong duty of loyalty.

Now, the problem with the costlessness standard, or all-other-things-being-equal standard, is that it is so hard to police.

Take the situation of the carpenters' trust, the pension fund run by the carpenters union. You are worried about that pension fund because there are great pressures on it to invest in iffy construction projects in order to engage in, quote, "job creation."

Let me warn you that there is a subsidiary plot here which is seldom understood. That plot is that in general, those jobs are going to go to the most senior workers because of the seniority rules; and therefore, what is really going on in this, quote, "job creation or social investing scheme," is in fact something by which wealth is being transferred away from young workers and toward older workers, but let me let that pass.

Now you have got the pension board, dominated by the carpenters union, and the question is, shall we make this investment to invest in some iffy construction project around here where we can get some job creation? What you do is you say, now, gosh, Ian Lanoff and everybody after him has said it has got to be costless, it has got to be everything else equal.

What you do is make some phone calls, you paper the file, you get some people to tell you that, yes, it is just about as good or it is as good, it is not going to cost anything, it is equal, and then you go ahead and do it.

After the fact, if the thing works out all right, then you will never hear about it. If it works out badly, people may not know what you did, and even if they do, it is very hard to unpack what you did. Because, as I said in my prepared testimony, the key difference is there is no market price. You can't look up in the *Wall Street Journal* and find out that the carpenters union took a 1 percent reduction in its yield. You can't look up and find out that the riskiness of that project was really known.

Remember something very fundamental. Our capital markets are the envy of the world. They are so fluid, they are so efficient. What you want to know always is, how come that deal had to go to the carpenters

union in order to get built? Why wasn't it able to get built down at the local bank which also does local investing?

The answer is because they knew better, and as a result, the tendency is for the dogs to come to the pension funds, the weakest investments, the ones that can't get taken up in the ordinary investment process out there in the free market. Those are the ones that come begging to pension funds and talk about incidental benefit, close quote, and all those other things. That is the game. It is a shell game. It is an enforcement problem.

Now, again, I don't want to overstate this. Ian Lanoff is absolutely right. The Labor Department has an enormous amount to be proud about. It stopped the worst of this stuff. But there is still too much of it out there and it is getting the last 10 percent that this hearing is about.

Representative Saxton. Thank you.

Mr. Sanford.

Representative Sanford. I just had a question for Mr. Rounds. I found your comments intriguing. I wanted to get just a few more examples, if you would, of divided loyalty. Have you seen many examples from a working standpoint that would be noteworthy?

Mr. Rounds. Well, let me give you examples from the common law. I defer to my colleagues for examples in the pension area. The classic example of divided loyalty would be a trustee who borrows from his trust fund. Another example would be a trustee who takes assets of the trust fund and invests them in his own enterprise. That would be divided loyalty.

And then things get more subtle but, nonetheless, just as serious. "I will invest the pension funds in your enterprise if you then do something for me." Or the trustee wishes to curry favor with someone, the government, for example, and proceeds to consider collateral considerations.

Or -- and there are examples of this in the common law -- the trustee's being hassled. People are pressuring the trustee to engage in a breach of trust of some kind, and the trustee acquiesces in order to get the people out of his office or whatever. That is also an example of a divided loyalty. It is very possible that if this take on a head of steam down the road, just to keep the government off his back, the pension trustee will look into collateral --

Representative Saxton. Will the gentleman yield for just one moment?

Representative Sanford. Please.

Representative Saxton. Are you saying that the Department of Labor, which regulates pension funds, could apply subtle pressure to pension fund managers to make these types of investments? Is that --

Mr. Rounds. I am suggesting at least -- and I am a common law lawyer. I defer to the experts here. But certainly looking at it from a personal trust common law perspective, it certainly is possible that down the road there will be subtle, indirect, unspoken pressure put on trustees which will cause trustees, for one reason or another, to unwillingly begin to invest in ETIs.

So I think it is misleading to think of it as just as we are not mandating anything or this is just encouraging or whatever. I think there is more to it than meets the eye.

Representative Saxton. Mr. Rounds, Mr. Langbein a moment ago concluded his remarks by saying that we are worried about the last 10 percent, you sound like you are worried about more than just the last 10 percent. You are worried about a portion of the other 90 percent as well.

Mr. Rounds. Well, I personally am, yes. I think this is a very unfortunate development. But, again, I defer to my pension colleagues. I just think that it has been rooted in the law for hundreds of years, that the trustee must act solely in the interest of the beneficiaries. When you start taking into account collateral considerations, what are the standards? Whose collateral considerations?

You know, that is why to some extent this interpretive bulletin is somewhat of a mess, to be frank with you. It doesn't really get into the standards by which a trustee shall define these collateral economic or social or political benefits. It is left wide open.

Mr. Lanoff. That is because they are irrelevant. The only economic factors are the ones that a prudent fiduciary can take into account.

Mr. Rounds. When you say economic benefit --

Mr. Lanoff. The noneconomic factors, whether they are social, political, are totally -- under this rule -- are totally irrelevant to the investment decision that a fiduciary makes.

Mr. Rounds. The implication is, however, that rather than looking after -- solely after the economic benefit of the worker -- we are going to look after some other more grandiose economic benefit, which really hasn't been defined, and who is going to do that defining? The individual trustee?

Mr. Lanoff. Called it incidental. He was satisfied with that as the test.

Mr. Rounds. Everything is incidental. I mean, if I put one of my trusts in IBM, I suppose I can be incidentally benefited by that. That is not what we are talking about.

Representative Saxton. If we can hear from one witness at a time. And we will give you an opportunity, Mr. Lanoff.

Mr. Langbein.

Mr. Langbein. Maybe I can say a word about --

Representative Saxton. I am taking your time here and I don't mean to do that.

Representative Sanford. Chairman, by all means, go right ahead.

Mr. Langbein. I am so sorry. Let me just say a word about incidental benefit. Every investment has incidental benefits. If you buy 100 shares of General Electric, you are supporting the capital markets, you are supporting the work that General -- you are lending, in effect, your money to General Electric. You are doing it indirectly by buying the shares from the previous person who did it, but you are, in effect, supporting the jobs and the economic activity of General Electric.

Everything has incidental benefit, and that is why I think Congressman Stark was perhaps sending us off on something of a wild goose chase in worrying that we would be -- we would be doing something awful if we were trying to exclude attention to incidental benefits.

The question -- the important question -- is the difference between your purpose and your effect. Yes, there will be incidental benefits for the economy in any investment. The question is, what is the fiduciary pursuing? What are his or her purposes and objectives? And in fiduciary law, traditional fiduciary law, the answer is exclusive benefit of the worker, and in ETIs and social investing and whatever euphemism you are using -- I loathe the phrase ETI because I think it is a new-speak euphemism that conceals the noneconomic. In any of these things you are trying to say, in addition to assuring the welfare of my pensioners and their beneficiaries, I am also trying to do something else, which is generate new jobs for the carpenters union or affect foreign policy in South Africa or whatever the particular cause is.

Representative Saxton. Thank you.

Mr. Manzullo.

OPENING STATEMENT OF REPRESENTATIVE DONALD MANZULLO

Representative Manzullo. Thank you very much.

My father belonged to a labor union and I won't say which one it is. Then when he retired, there was no money left. This was all before ERISA had taken effect. In fact, when he retired, the first statement he got was that the total benefits would be $28 a month. This was after paying into it for years and years.

And the next statement was something to the effect that all the money was gone. And I think the mere fact that we are having a discussion as to change the nature of the manner of investments, should send a flag up the pole of every labor union in this country, and every business and every person who has put any money into any private pension plan.

And the issue here is, if this rule, if the section 404 statement that was -- that has just been made really doesn't change any existing law, it is really a restatement of the same sound principles of prudent management, then why is the statement made again? It is just -- it is simply -- it simply does not make sense.

I contend that this is a $4 trillion dollars slush fund so Democrats can go out and say, look what I am doing to build infrastructure; and by the way, folks, your pension money is going to build this great public housing project, most of which fail, and then 25 years from now you can see the detonators come in and lower four buildings all at one time and then everybody becomes dependent upon the government to bail out the people whose pension money has been squandered by social theorists.

I think this is disgraceful, what the Clinton Administration is trying to do, and I am quite shocked at the amount of silence on the part of pension fund managers and the labor unions that are going along with this and saying, well, you know, maybe there is an argument for or maybe there is an argument against it.

When I practiced law and got involved in a little bit of trust law, if there was an argument against it, then you didn't do it, because that meant that there was an element of risk, and the mere fact that somebody had to question that there was a change in -- that there is going to be a change in the standard, I mean, after the S&L debacle, this -- you know, we might as well be building snow slides in New Orleans or exotic beaches up in Alaska and trying to change the weather and say that by using all this money, it is going to be a great social project.

Well, I will tell you, in an era where taxes have become known as contributions and spending as investments, I would just hope that this

Congress will do everything it can to pass Mr. Saxton's law, which I am -- a bill of which I am a co-sponsor. I would hope that the President would wake up, and I notice the tremendous number of Democrats that are here to rally around the flag so they can have their own press conference and they can stand before the American people and say, folks, I want to tell you, look how we are going to invest your pension money, the same way we are running this government.

And isn't it interesting, Mr. Chairman, that the exact amount of money they want to use is almost the amount of money that equals the national debt, about $4 trillion? In fact, they might as well just say, we are going to take all the pension money, we are going to pay off all the national debt and start all over again.

Mr. Lanoff, I have got a lot of respect for you, but I want to tell you, I just find that your testimony is -- I am not saying it is not hard to believe because that would insult you. It just reaches the point where, when sound, prudent people disagree on whether or not the law should be changed, then it really shouldn't be changed and we should err on the side of safety.

Would you agree with that?

Mr. Lanoff. I am the one who authored the prudence rule which deregulated the entire investment area for pension funds and opened the way for investment professionals and experts to take risks within the context of the entire pension portfolio. So I am an enemy of the type of no-risk rules that State legislatures once passed that banned investments by pension plans, for example, in stocks, because they thought those were too risky.

I am in favor, under ERISA, of leaving it to the experts, and if the experts deem investments to be sound investments, I don't care what other incidental factors those investments involve. If they are sound economic investments, in my view, under ERISA, they have done their job and the fiduciaries have done their job to protect participants and beneficiaries. There is room for risk, however.

Representative Manzullo. There is always room for risk. But are you saying that there should be a -- I don't want to use the word lessening of standard because a fiduciary is a fiduciary -- but are you saying there should be a change in the law?

Mr. Lanoff. No. I am saying the opposite. I am saying that the law stands. We interpreted it back in the 1970s and that nothing that has been done by successive Labor Department personnel since that time has changed what we did and what Congress did one whit.

Representative Manzullo. Your colleague is disagreeing.

Mr. Langbein.

Mr. Langbein. My view is that Mr. Lanoff did a wonderful job back in the late 1970s --

Representative Manzullo. He should have stopped there.

Mr. Langbein. -- in prohibiting most of the mischief, and I also think he did a wonderful job in the area that he is referring to, which is getting prudence standards in there and not attempting to engage in categoric regulation of types of investments. ERISA fiduciary law has been, in general, a real success story in this respect. I agree completely.

Where I disagree is on the question of the costlessness standard for social investing. And there, as my testimony this morning indicates, I think there is still room for mischief of a sort that you are wise to be concerned about and ought to stop, and it is easy enough to stop it.

The way to do it is to amend ERISA 404 so as to insist that investments be profit maximizing only. Do not allow people to take into account noneconomic criteria. There will be plenty of noneconomic consequences. They will be in general for the good, but let individual pensioners do their own politics. Deliver to them maximum investment returns in their pension funds. Let them decide what political causes and what social causes they want to participate in.

Representative Manzullo. Mr. Chairman, may I have two minutes?

Representative Saxton. We are going to have to wrap up real soon.

Representative Manzullo. My wife and I have a small savings account at a place called Dwelling House Savings and Loan. It is in -- it is in Philadelphia. It is a minority-owned Savings and Loan, and it is a father and son team, and they guarantee that you will get a lower rate of interest and in exchange for that, they take that money and they lend it to people in inner cities so they can buy homes. They brought back home ownership in the inner city in that particular area from 17 to 47 percent, and we knew that.

It is a modest amount. We will never take that $500 out, but I would say that if people are interested in social investments of that nature, then those are the accounts where you know up front there is going to be some risk. But my wife and I are proud that we are doing something to combat crime and to bring back the housing in the inner city where funds otherwise may be scarce, and I would suggest that people who are interested in making social investments, and these are worthy, look to separately segregated funds for that particular purpose.

Representative Saxton. Thank you. We are really going to have to move on to the next panel. So I want to thank you. And in thanking you, I would just like to note that it appears there is a great deal of agreement between all three of you on these issues and that it is appropriate, I think, to note at this point that we agree also with, I think, all three of you, that pension fund managers ought to be the decisionmakers in this case and that is why we introduced a bill which says, from our point of view, the Administration has misrepresented the intent of ERISA.

And our bill simply prohibits the Administration from further spending Federal dollars to encourage the investments in what they refer to as ETIs. Thank you very much. We appreciate your being with us and we are going to move quickly on to the next panel.

And while the next panel is moving forward, let me introduce them. Wayne Marr is the first professor of finances at the Business School of Clemson University. He served in the SEC under President Reagan and is the author of over 80 professional and trade articles and over four of those are on the topic of ETIs. I would like to particularly thank Professor Marr for coming today despite the fact that he injured his knee within the last 48 hours. Hope you are feeling better. You overcame the difficulty to fly from South Carolina today.

Also, Edward Zelinsky, professor of law, Benjamin Cardozo School of Law where he specializes in Federal income tax, business planning, and pension and profit-sharing plans. Mr. Zelinsky also holds two degrees in economics from Yale. He is widely published on the issues that I just mentioned. We thank you for being here Mr. Zelinsky.

James Pugash is the President of Hearthstone Advisors and is active in promoting ETIs in real estate in California. I would like to welcome all three of you here today. We will begin with Mr. Marr.

PANEL III

STATEMENT OF WAYNE MARR, PROFESSOR OF FINANCE, CLEMSON UNIVERSITY

Mr. Marr. Thank you, Mr. Chairman.

If I have a grimace on my face, it is not from what you said. It is probably my knee is killing me. I am going to cover a little bit of my testimony, but only the highlights of it because I think some things are very common sense in ETIs.

My testimony has been in preparation for four years. We have been doing research on it with respect to Economically Targeted Investments.

I think it comes down to a very simple question. If you look at the capital markets as they exist today, you see social investments. For

example, TIAA/CREF has a social investment that I can put my own money into. I have yet to see a mutual fund that has an ETI account. I would also venture that very few people in this room right now -- okay, I saw the red light -- would put their money into any ETI mutual fund. You just don't see any ETI mutual funds being sponsored by Kemper and others. It is relatively simple. There is really no market demand for it.

Now, our tests indicate that if you look at ETIs and someone said it earlier, the abuse and the misuse of funds are primarily at the State and local level and that is where the evidence on ETIs are.

The evidence is, we find that funds that invest in ETIs, and we hold a lot of things constant, we use the correct econometric technique to attempt to back out the information because we would like to have individual return data for those ETIs, but it is never given to you. You can -- that is always considered proprietary, likely because it is a failure, is that it is anywhere from 100 basis points, which is 1 percent to 200 basis points, which is 200 percent below a comparable fund.

Now, in our latest research we find some of that is related to governance characteristics, and we have backed all of that out because of the way state and local governments operate relative to the way private funds operate, but you are still talking about a substantial loss in revenue.

Now, that begs a question. Why would anyone at any level pursue a suboptimal investment policy? Well, what we relate it back to in a very simple sense is that I believe -- I am going to pronounce your name wrong, Mr. --

Representative Manzullo. Manzullo.

Mr. Marr. -- Manzullo said it best. He is investing in a minority bank in Philadelphia that is basically doing what he thinks is right. There is a consumption value for him, as economists would say. He thinks that what he is doing -- he and his wife -- is right.

Many people will invest in social investments. That is why companies don't invest in South Africa, they don't buy -- they don't invest in companies in Northern Ireland, blah, blah, blah, you can go down the list, because they feel that is the right thing to do and they will sacrifice return for the risk. That is a personal decision, okay? That is a private fund. They exist. It works.

Now, you don't see the comparable in Economically Targeted Investments. It is simply, no one is interested in it. Why? Because most of them are political giveaways. The reason is the consumption value to me as an individual, to say to Mr. Saxton, he is not going to be out cutting the ribbon because someone is going to build a new baseball park, we will

say, with public funds, but I will tell you what, the pension trustee or the pension manager of that fund will likely be on hand to cut the ribbon and they will say, "geez, our money helped build this park, whether it is profitable or not, whether the cash flows are conducted properly or not." They derive a tremendous consumption value out of that, which the beneficiaries don't.

The other thing which is never said, or very rarely mentioned, is that if I retire with TIAA/CREF, which I can take anywhere, I am not interested in, at that time, TIAA/CREF investing in New England if I am not going to live there.

Now, I debated this point with the Commission of Mario Cuomo who did a lot of the early ETI stuff in the late 1980s. Lee Spencer is Chairman of Excelsior Capital; don't know if it exists anymore, with the argument if you are in New York State and you plan to move out, that is the wrong decision you made. You don't need to move to Florida to retire.

Well, a pension fund -- you don't invest in a pension fund because they invest in roads or infrastructure around the United States, because you are going to stay there and you are going to benefit from it. You are investing so you can have retirement income at the end of your life or toward the end of your life so you can enjoy it, not for any roads or buildings or other things that the government should be basically going through their budget and making investment decisions themselves.

It is basically a way for many politicians, and I would tend to agree with some of the statements that are coming out of here, that you can go ahead and use public pension fund money to build projects that they are not willing to fund themselves or they can't find the money to fund and they can say, "gee, we built new housing projects, by the way, we used $250 billion of pension fund money," -- and I think that is a critical number.

Realize, today in private pensions alone, we are talking about $5 trillion in assets. If you encourage, which I think the prior panel, I thought, did a reasonably good job, encourage is very similar to mandate. There are a lot of ways that companies can gain. They can trade off projects, they can do projects, they can lend money to themselves. There are a lot of things that can happen. In that is 5 percent of $5 trillion. It is $250 billion that is basically political fodder or political money that can go anywhere. Okay.

[The prepared statement of Mr. Marr appears in the Submissions for the Record.]

Representative Saxton. Thank you very much. Mr. Pugash.

STATEMENT OF JAMES Z. PUGASH, PRESIDENT, HEARTHSTONE ADVISORS

Mr. Pugash. Thank you, Mr. Chairman.

If you permit me, I would just like to correct for the record. You described me in your introduction as someone who is actively promoting ETIs in California. We definitely do not see what we do as being promoting ETIs. I have an investment company. It is called Hearthstone Advisors and we pioneered the concept of pension fund investing in single-family home building. We did it not because we thought home building was a target investment, but because we thought there was a good investment opportunity here.

Representative Saxton. Thank you for clarifying that for us.

Mr. Pugash. It is important because it suggests a bias on my part which I surely don't have.

I am President of Hearthstone Advisors. The money that we use, we invest in the construction of single family homes. Our portfolio includes nearly $1 billion of commitments in 45 home building projects. We are building about 6,000 homes in California and are starting to take our program to other parts of the country.

At Hearthstone, we have only one objective: It is to earn as high a return as we possibly can for our investors while avoiding unreasonable risk. To date we have had some success. Our portfolio has averaged a return of over 20 percent a year. Of our 45 investments, our worst will break even and our best will yield over 50 percent.

Because of our track record, and this relates to my opening comment, Mr. Chairman, we have been able to attract many blue-chip investors, including public and private pension plans, and nonpension plans, for example, General Motors Acceptance Corporation. This is simply a financial investment for GMAC, the Endowments of Stanford, Dartmouth, MIT, University of Michigan and others.

I can assure you that most of our investors, like ourselves, have no interest whatsoever in targeted investments. Nonetheless, our investments do create jobs. They provide housing for the middle class and they help communities grow. And by an accident of our birth, our first major investor was CalPERS and our first major investment program was limited to California. As a result, we frequently find ourselves in the crossfire of the debate on ETIs and we have some observations that I would like to make which may be relevant.

And here I am going to depart from my written testimony because many of the points I was going to make have been made by others.

First of all, as Professor Langbein said, too much time is spent on the question of whether a targeted investment can be profitable or generate the kind of return as a non-targeted investment. I think the answer is obviously yes. Our returns are excellent. I think we are one of the best real estate investment managers in terms of our returns in the United States right now.

I think the real question that you want to ask, as you consider this subject, is whether pension fund trustees can be trusted to make the right decisions if they can take collateral benefits into account. Professor Langbein put it differently, but it is the same question: Is the fudge factor too great? Is the costless route really something that doesn't exist in practice?

Let me give you some of my reactions based on my expertise and experience talking to pension funds. First of all, I think the answer to these questions has to be divided between public and private pension funds because they have totally different investment orientations.

Public pension funds require very careful protections in the law for their beneficiaries. The political pressures on public pension fund trustees are enormous to make social investments when many are willing to accept substandard returns, and I just want to be clear for the record that I am excluding CalPERS.

CalPERS has a very firm policy that they will not accept substandard returns, but I am aware of the fact that other public pension funds have made a lot of big mistakes because they have been focused on the wrong things.

They are not subject to ERISA, and based on my understanding of your bill, Mr. Chairman, it will not address this problem, which is something that you might want to think about.

With respect to the private funds, the private plan sponsors, let me share my experience. When we tried to organize our company to raise funds for single-family home-building, it took me three years to find an investor that would invest in our fund. I talked to over 600 institutional investors, and incidentally, the program that we have is exactly the same program that H.F. Ahmanson -- which is the largest thrift in the United States -- it is exactly the program that H.F. Ahmanson had, but Congress, when it passed FIRREA, legislated the thrifts out of that business.

I see my time is up, but I will just make the comment that out of 600 investors, if I mentioned social investing to one of them, they would immediately slam the door on me and tell me to get out. It is the last thing that they wanted to hear about.

So my point simply is, I don't think that the private pension fund community is interested in social investing, and that it is not really the thing that you really need to focus on.

Thank you.

[The prepared statement of Mr. Pugash appears in the Submissions for the Record.]

Representative Saxton. Thank you, and I apologize for misrepresenting your activities in life, and I appreciate very much your clarification on that matter, and it sounds as if you have a very up and coming, up and going operation and we appreciate you coming here to share a few minutes of your experience with us.

Mr. Zelinsky.

STATEMENT OF EDWARD ZELINSKY, PROFESSOR OF LAW, BENJAMIN CARDOZO SCHOOL OF LAW

Mr. Zelinsky. Mr. Chairman, like many who preceded me, I will put my formal testimony in the record and discuss some of the highlights. I have also placed in the record an article on this subject, Intrepretive Bulletin 94-1, which will appear in the *Berkeley Journal of Employment and Labor Law*. One of the reasons I can speak in brief terms now is because, in that article, I don't speak in brief terms at all.

I would like first to focus on the inherent paradox of the Labor Department's definition of Economically Targeted Investment: We were told again today that Economically Targeted Investments produce market-adjusted rates of return.

There is a tremendous paradox to this definition because investments carrying competitive rates of return will, over reasonable periods of time, be made under normal market criteria. There is, thus, no need for the tremendous solicitude that is being extended towards what are called ETIs. If such investments produce competitive returns, as we are told ETIs do, these investments will be undertaken by virtue of normal market forces.

If, on the other hand, these Economically Targeted Investments are being shunned in the marketplace, that is a good indication that these investments do not yield competitive returns. Hence, the DOL's encouragement of ETIs is either superfluous, since the market would have made these investments anyway, or it is wrong, since the market is indicating that these investments should not be made.

Second: in anticipation, of the criticism I just advanced, it is common for proponents of ETIs, as well as the Department's own material supporting IB 94-1, to argue that Economically Targeted Investments are to

be found in very flawed markets. But such a defense merely compounds the paradox; because if proposed ETIs are found in seriously imperfect markets, then pension trustees cannot be confident that such investments yield the promised competitive rates of return. Moreover, if there are serious problems of market imperfection, the appropriate public policy is to deal with those imperfections, not to send pension trustees charging into poorly functioning markets.

Third, equally problematic is the confidence with which ETI proponents claim that they can identify collateral economic benefits. Indeed, I would argue that the entire ETI category is so subjective as to be worthless. Many of the supplemental benefits that are typically claimed on behalf of ETIs can just as plausibly be found in more conventional investments.

We heard again today the argument that venture capital projects yield auxiliary economic benefits. There is much romance in this notion, but no hard reason to conclude that new start-up enterprises generate more positive externalities than less glamorous, more traditional deployments of capital. There is, however, emerging the significant danger that the highly subjective process of identifying externalities will degenerate into a brawl for the control of pension monies, a brawl in which the winner's victory will be rationalized in terms of collateral economic benefit.

Finally, speaking as a lawyer, I have to say that IB 94-1 and its support of Economically Targeted Investments are simply incompatible with the language and policy in ERISA. The statute says what the statute says, the exclusive benefit rule is just that, a rule which proscribes pension trustees from considering, not incidentally creating, but from considering any factors other than the interests of plan participants.

Rather than grapple with the language of the statute, the proponents of IB 94-1 tell us that IB 94-1 merely codifies existing interpretation of ERISA. As I demonstrate more fully in my article, this administrative precedent argument is unconvincing. The specific administrative material that is cited in the prologue to IB 94, when examined carefully, proves slender and unconvincing.

The bottom line is that, like many who have preceded me, I am a strong supporter of H.R. 1594 and I would urge that it be reported favorably.

[The prepared statement of Mr. Zelinsky appears in the Submissions for the Record.]

Representative Saxton. Thank you all very much.

Let me just ask one question of Mr. Pugash, and then I will yield to my colleague.

You raised a very interesting point, I think, about public pension funds in particular and political pressure that comes to bear on the fund managers. And I think that is very correct, that we should be worried and concerned about those pressures, and that is one of the reasons that we are here today discussing that very possibility with regard to private funds.

This Administration obviously is conducting some activities that concern us in that regard by spending almost a million dollars to create and run a clearinghouse with the clear intent of encouraging this type of activity, and it seems to me that the use of the term "encouragement" could certainly include activities and ramifications of those activities which have something to do with a regulator encouraging and slipping into subtle political pressure. Would you share those concerns?

Mr. Pugash. Well, the difficulty, Mr. Chairman, as you know, is that ERISA's "prudent man" standard does not apply to public funds, and there are many funds that have acknowledged that they are willing to accept below-market returns because they are pursuing collateral benefits. That is the concern that I have.

If you have a fund like CalPERS, for example, which clearly and explicitly follows the "prudent man" standard of ERISA, CalPERS' sole objective, I have seen, when they have made their decisions, is for their beneficiaries, and clearly what they are doing is right. But where there may be a need to do something is in places where that "prudent man" standard does not apply.

Representative Saxton. Do you share any -- do you have any concern with regard to pension funds that are administered pursuant to this Federal statute that tinkering and encouraging brings to bear political pressure?

Mr. Pugash. This is just an empirical observation. I don't share the concern simply because, from my own experience, I found that making a social benefit argument to a private pension plan is a loser every time. I mean, I just don't do it because they are interested in risk and returns; and as someone said earlier today, if I were to start talking about social benefits, if anything, it is going to send them running for the door, and so I am not concerned about that.

Where I would be concerned is if a public plan doesn't have the prudent man standard, prudent person standard, then there is big potential for mischief.

Representative Saxton. Thank you.

Mr. Manzullo.

Representative Manzullo. Thank you very much, Mr. Chairman. I am very much impressed with the quality of the panelists. You know, so often in the area of economics -- I don't mean anything to our staff at all economics, because you know the Will Rogers story about economics and I don't want to repeat it here, but I am very much impressed with the practical application.

Maybe, Mr. Pugash, you could clear this up for me. If I were the trustee of a private pension plan and you came to me with just one housing project and said, Don, I want to build 100 homes. It is in an area of the city that is safe, the schools are good, it is not getting beat up by a magazine, the crime is down -- and you would like me to invest say -- I guess the first question is the extent of the amount that I would put into it, that would determine it.

But based on those circumstances, and I made an investment with you and provided you had a good credit rating, which I am sure you do, and it is a worthy company and you are following the law, would that be a sound investment within the prudent man's standard or would we have to add other factors into it?

Mr. Pugash. I would have to know more, but offhand, let me say an investment in one housing project -- unless you had a huge portfolio, you were a wealthy man and you were invested in other things, I would be concerned you were not adequately diversified.

Representative Manzullo. I noticed you had 45 projects.

Mr. Pugash. Right.

Representative Manzullo. Is it the volume that you do, the diversification, and the amount of capital -- the percentage of the amount of capital that would come from a fund or is it a combination of all those that would determine whether or not it is a prudent investment?

Mr. Pugash. All of those things have to be taken into account. We are in a business that most of my colleagues were doing the same thing for a New York Stock Exchange company before we got money from CalPERS. So we are out to make money, first, for our investors, and if we can make some after that, that is great.

But you have to look at the risk, returns, diversification, and in the case of CalPERS, they spent a year studying this before they decided to do it. And it is interesting, I had dinner with the Chairman of CalPERS Sunday night and I asked him, were you concerned about the collateral benefits when you invested in our program? Because people think that

this was the only reason you did it, and he said, no, absolutely not, we didn't even talk about that in our sessions. We wanted to make as much money as we could for our beneficiaries.

And I am not disputing the fact that -- the other gentlemen have points that they have made that there are abuses here. What I am saying is really what Professor Langbein said, that if you have the ERISA standard, it has a huge in terrorem effect, as lawyers say, hanging over these trustees, and if you really want to go at the heart of the problem, it is to get that standard applied to funds where it doesn't apply today.

Representative Manzullo. Let me ask another question. I don't really know if you gentlemen have the answer.

Mr. Chairman, have we heard from any trustees' bonding companies over these ETIs? I would be interested in knowing -- the ones who write the bonds, the surety bonds.

Representative Saxton. We haven't heard from them.

Representative Manzullo. For performance, but I -- if it would be possible, I think it would be of value at least to get a letter, or if we are going to have a further hearing, the ones that are involved in the risk.

Thank you very much.

Representative Saxton. Mr. Zelinsky, you testified that IB 94-1 is inconsistent with the consistency and loyalty embodied in ERISA. Why do you say that?

Mr. Zelinsky. For two reasons. First, the statute says what it says. It codifies the common law standard, and the common law standard is the exclusive benefit standard. Exclusive benefit does not mean sometimes; it doesn't mean all other things being equal. The statute says what it says.

Second, when you examine the supposed administrative precedent cited on behalf of IB 94, it is clear that something of a game is being played. Administratively, three types of rulings are used by the Department in its defense of IB 94-1. There is a set of prohibited transaction exemptions which the Department of Labor (DOL) cites. Each and every one of those exemptions does not say that these are acceptable investments under the prudent man's standard. In fact, these exemptions careful to say just the opposite.

Also cited by the DOL are three opinions that issued under the ERISA procedure, two with respect to the Chrysler-UAW arrangement. In both opinions, the Department ignored the language of the statute, substituting for the word "exclusive" the word "ordinarily." The DOL does that explicitly and openly; that is the kind of move that indicates to a lawyer that a game is being played.

In short, when you go through those supporting materials, there are far less impressive administrative precedent than has been represented.

Representative Saxton. Well, thank you. I asked you that question because the very first sentence in the bill we have introduced says, "It is the sense of Congress that Economically Targeted Investments violate sections 403 and 404 of the Employee Retirement Income Security Act of 1974."

Mr. Zelinsky. I think that is clearly a correct statement.

Representative Saxton. Thank you all for coming. We have to go vote again. We appreciate your being here.

I would like to thank you very much, and before I leave, I am going to introduce the next panel so they can make their way forward during the time that we are away.

Kimberly Schuld is a political and policy strategist responsible for assisting with the development of legislative and adequacy programs for The Seniors Coalition. She is a former chief of staff to California State assemblyman Paul Horcher. She represents, I think, the mainstream of senior citizen thought.

Also, someone who is no stranger to those of us who have been around here for a few years, Beau Boulter, a former colleague, is now an attorney practicing in Texas and in Arlington. In the spring of 1994, he was a resident Fellow of the Institute for Politics of the John F. Kennedy School of Government. Welcome to Mr. Boulter.

And Dan Schulder is the Director of Legislation for the National Council of Senior Citizens, a senior citizens group that represents union employees located, I believe, here in Washington.

Welcome, and I will be back as soon as I can get here. Thank you.

[Recess.]

Representative Saxton. Let me thank you for your indulgence. As Mr. Boulter knows, these things happen around here. Good to see you back with us, and thank you for your indulgence here.

So we will start this panel's testimony with Ms. Schuld.

PANEL IV

STATEMENT OF KIMBERLY SCHULD, POLITICAL AND POLICY STRATEGIST, THE SENIORS COALITION

Ms. Schuld. Thank you, Mr. Chairman. Thank you for inviting The Seniors Coalition here today to discuss the Administration's plans to pursue economically targeted investments for private pension funds.

In taking a look at this issue, The Seniors Coalition made its evaluation based on what was in the best interests of the pensioner, the actual earner of the money, and the available evidence concerning these ETIs weighs heavily against the pension earner being the primary beneficiary of the investment. Specifically, we are concerned that ETIs will politicize private pension funds, they will provide lower returns on investments, and finally they will serve to stagnate efforts to increase national savings and investment on the private side. For those reasons, The Seniors Coalition endorses your efforts with H.R. 1594 and is opposing the pursuance of ETIs.

As you opened the hearing this morning with the language of ERISA, it is very explicit that that language is intended to protect pension funds. We feel that is adequate, and a reinterpretation of that language is a political manipulation of pension funds. In terms of politicizing pension funds, the best examples currently exist within the state public pension ETI investment schemes.

In 1993, in the Columbia Law Review, Roberta Romano, who is a pension expert, wrote that the "oil and water mix of politics and investing is invariably present with ETIs, that the political affiliation of many trustees makes public pensions especially vulnerable to pressure by State officials." I just wanted to cite some examples of an East Coast plan official that said, "In many States, the office of treasurer is a quasi-political office. People who aspire to political office do things that aren't in the interest of the fund." A West Coast counterpart also stated that, "Any drive to do ETIs comes from politically active members of the pension board."

It is not difficult to anticipate the same political pressure being placed on private pension fund managers, especially in organizations where you have politically active board members who are not government employees but nonetheless political people. We also feel that the politicization of pension funds places the fund manager in a difficult position with torn loyalties.

ERISA was established to specifically detail what that loyalty should be -- it should be to the pensioner -- and this effort divides that fund manager's responsibilities to the point that even current state fund managers report they have a great deal of difficulty in performing their duties because of the encouragement that they receive to invest in ETIs. And one chief of staff of a state fund even extended that to the point that he stated, " the Federal Government is using the threat of revoking the pension fund's tax exempt status in an effort to encourage their recep-

tiveness to ETIs at the state level." The bottom line is when the manager serves several masters, there is no way to achieve fairness and parity.

Beyond just the individual fund manager is the issue of who determines what is an economically targeted investment, what is good social policy and as all those familiar with this town know, that momentum, once it is begun, never slows down. The Federal agencies are not immune to political pressure, and that is evidenced by actions of a variety of regulatory agencies in town. The imposition of political pressure by outside groups does adjust their priorities and their output. The attempt of the Administration now to obtain new revenues for a social agenda is, in our opinion, irresponsible to the individual investor but more importantly, it is indicative of a pattern of placing government squarely between the money earner and the money that that person earns, and the members of The Seniors Coalition believe that the government has to get out of the way of the money and the earner.

A second reason we are concerned about the pursuance of ETIs is the fact that there is ample evidence that they produce lower returns on investments. I am not going to go through the list of them because we all are familiar with them, but I did want to make a comment quickly.

Alicia Munnell, who is one of Clinton's nominees for the Federal Reserve Board, did a study in 1983 of mortgage investment funds in 31 states. On the state level, a large number -- an overwhelming number of ETIs are mortgage investments. In that study, she found that there was either an inadvertent or even deliberate sacrifice of return on the investment itself.

Also, despite Ms. Berg's claims this morning that there is no inherent risk in ETIs, in June of 1994, she wrote a department bulletin which outlined the inherent risks in some ETIs. I don't know that those inherent risks have gone away or if she forgot about the bulletin, but people within the department that are promoting the ETIs are identifying that there are risks.

And finally, the Labor Department is circulating Richard Ferlauto's article which goes one step further in outlining the inherent risk and actually states that the risks are so great that we have to have a contingency plan of subsidizing the losses.

With that in mind, The Seniors Coalition firmly believes that the ETI scheme is not in the best interests of the pensioner.

Thank you.

[The prepared statement of Ms. Schuld appears in the Submissions for the Record.]

Representative Saxton. Thank you, Ms. Schuld. Mr. Boulter.

STATEMENT OF BEAU BOULTER, NATIONAL ADVISORY BOARD, UNITED SENIORS ASSOCIATION

Mr. Boulter. Thank you very much, Mr. Chairman. I will just summarize my testimony, with your permission.

At the United Seniors Association we are very, very grateful for the efforts you are making and for the watchful eye that your Committee and that you personally have on this problem because we are really concerned that the Clinton Administration, with their announced plans, their unannounced plans, covert-overt, whatever, we are very, very concerned with what appears to be a targeting of these pension plans, with what appears to be a real threat to the income security of millions and millions of seniors.

I have heard the Speaker speak on this subject, and just want to state my agreement with his remarks on your bill, Mr. Chairman, because he said that the Clinton Administration knows that it cannot further its liberal social agenda simply by raising taxes with this Congress. It understands the anger and revolt of the American public against a bigger and bigger government that encroaches more and more.

The Clinton Administration has lost unfunded mandates, and there just aren't too many sources that it has to look to for money. But, apparently, it has thought of the pension plans that have been built up over the years by American workers. And the other thing that I would add to what has been said here today is that retirement plans and plans that seniors have contributed to are going broke.

I would just cite the Medicare trust fund, the Social Security trust fund itself -- down the road, some people say 2030, some people say 2012, whatever, they are also endangered.

Now, do we want to place the pension funds also at risk? Of course we don't.

I sat through the testimony of the legal experts, and it was really interesting to me because I used to litigate trust and estate cases before I was elected to Congress, and I just know that the only standard for an investment decision by a trustee or a fund manager -- the only standard is what will benefit the beneficiary. There is no other standard that should come into that person's thinking -- not any political reason, not any social consideration whatsoever -- because these funds are private property. And it just amazes me that this Administration really doesn't seem to understand that other countries can make policy loans. I mean, China does that,

the World Bank does that, but that is not what made America great; that is just not our system.

Our system is built upon private property rights. These pension funds are private property. These corpuses were built up after many, many, many years of hard work, and they should not be raided to further a liberal social agenda. That is the view of United Seniors Association.

So we are going to be asking every Member of Congress to back your legislation, to take a pledge not to allow these pension funds to be raided because that is what this is. That is what this is, and it just scares us to death.

So we really congratulate you for your efforts. We support the Pension Protection Act of 1995 and want to work with you for passage.

[The prepared statement of Mr. Boulter follows appears in the Submissions for the Record.]

Representative Saxton. Thank you very much. Mr. Schulder.

STATEMENT OF DANIEL J. SCHULDER, DIRECTOR OF LEGISLATION, NATIONAL COUNCIL OF SENIOR CITIZENS

Mr. Schulder. Yes. Thank you for this opportunity to discuss your bill and the status of private pensions in this country. I have been here through the whole hearing, and I have used my time also to read some of the papers, and I think this hearing has been a sham.

I don't think there is any evidence that has been presented here that there is any significant risk to the pensions of older Americans, either implicit or explicit; and in fact, with some of the predecessor -- previous witnesses here, if they know of this sort of corruption, I wish they had gone to their Federal DA or their state law enforcement people, because they have not said that there has been corruption or a twisting of the requirements of ERISA.

We think that older persons are as concerned with the needs of their communities and their children and grandchildren as they are their own concerns. And therefore, they don't object when their money is invested in secure kinds of investments that also have a payout for their communities or for workers in their former industry, if they are trade union, or for the general public.

Market-driven programs are not necessarily good for everybody in the society. What I hear today is the only time people get tense is when these monies are invested in behalf of workers or low-income persons or communities that need those investments, but everybody is happy when Orange County makes investments and they lose it, or TWA goes under, et cetera, et cetera, et cetera.

We do not support your legislation, sir. We think it will freeze and suppress innovative ways to utilize pension money.

We don't believe there is a threat to pension funds. In contrast to Mr. Boulter, we don't see a problem in the Social Security trust fund going broke. This society, this government, will not let those things go broke. They are always a challenge. They were made to be flexible, and that is what is happening. We have a dynamic economy and a dynamic population.

So, in conclusion, we don't support your proposal. We think it will, in fact, lead not to more secure pension funds but rather a restriction on the investment of funds which will not be to the benefit of covered workers; and we can sleep well with the current program. We think this Administration and this Department is doing a good job of widening the opportunity for investment and not suppressing it.

Thank you very much.

[The prepared statement of Mr. Schulder appears in the Submissions for the Record.]

Representative Saxton. Well, thank you very much, and we appreciate your being here with us today to express your opinon. Let me just ask each of the three of you just one question, and let me just start with Mr. Schulder.

You may be familiar with an individual that Ms. Schuld mentioned a few minutes ago, Mr. Richard Ferlauto from the Center for Policy Alternatives here in Washington. He is also a supporter of the current Administration policy -- I think that is fair to say -- on ETIs, but he has a concern which leads him into a position where he believes that we ought to establish a federally funded insurance fund to ensure the viability of ETIs and to compensate those pensioners or would-be pensioners if the fund should fail or suffer losses.

I am wondering, in your opinion, why do you suppose this supporter of ETIs feels the necessity of having a Federal fund to support the program if it is -- if the idea is so good?

Mr. Schulder. Well, I wouldn't know why he would come to that conclusion. If, in fact, these are so risky and they are violating the ERISA rules, then they should be disallowed. The Department of Labor should crack down on them. Therefore, you don't need, it seems to me, a backup fund to pay the beneficiaries in such funds if they go under because of these investments.

The point is, if they are violating the rule, then don't let them make these investments; enforce the law. You don't create a welfare program out of a normal investment program for pension funds.

Representative Saxton. Mr. Boulter.

Mr. Boulter. Well, Mr. Chairman, it is really not -- risk is really not what we are talking about. Every investment carries with it some degree of risk. What we are talking about are motivations other than what is in the best interests of the beneficiary and I heard the witness say that market-driven investments are not necessarily good for society.

Well, that is what I tried to say in my opening remarks, that people who agree with this witness, like in the Clinton Administration, they think that these kinds of policy investments are great.

Well, it is one thing to do that with your own money, or even with tax dollars if you can raise them, but it is quite another thing to do it with money that people have built up through a lifetime of hard work and savings. And, you bet, if the standard is lowered by political and social and policy considerations and if they start entering into how these fund managers invest these pension funds, then you are going to need some sort of insurance agency or Federal agency, like Federal Deposit Insurance Corporation (FDIC) or something, because you are going to have a big debacle on your hands down the road possibly, like the S&L crisis or something like that.

Representative Saxton. Ms. Schuld.

Ms. Schuld. Well, I can only really speculate on what Mr. Ferlauto meant, but I think it is fair to say that his concern about the loss of revenues in pension funds and his plan for how to come up with those revenues is a good indication of the fact that ETIs economically are not in the best interests of the pensioner. And it has very little -- as Mr. Boulter said -- not a whole lot to do with illegal or terribly risky ventures. It is not about corruption, it is about motivation, and that motivation is obviously a third party, not a party interested in the pensioner's benefit. And it is difficult for me to understand how the Clinton Administration can advocate for increasing private savings and investments and pursue programs like this, which would serve to, in an economic reality sense, decrease private savings and investment by taking what could have been privately invested and, instead, turning it into a taxpayer subsidy to a bad investment for social good.

I don't understand the reasoning. It is illogical and it is incompatible.

Representative Saxton. Mr. Schulder.

Mr. Schulder. Mr. Stark earlier, and perhaps one of the other witnesses, mentioned the idea of local community investment that banks engage in, and the banks' philosophy is that the good of the community, the economic good of the community is good for the depositors, and so they invest in the local community. I don't think that is an illegitimate reason as long as the investments are sound in terms of motivation to make such an investment.

ETIs often, as I note in my testimony, are doing what banks used to do, that is, they are going into smaller markets, into smaller businesses, and making investments and getting returns on them.

Let me just say one last thing, if I could, sir. There is that definition of Puritanism that says that it is the irritating thought that someone, somewhere might be being happy, and it seems to me your bill is sort of a corollary of that. It is the nagging suspicion that someone else, somewhere may also benefit from this investment, and I don't think we should be afraid of that.

Representative Saxton. Let me just ask you a question.

Back in the decade of the 1980s, a Florida carpenters union invested 100 percent of its funds in real estate, and I suspect that that was partly because they wanted to make the community better, and I suspect it was also some motivation there to provide some jobs for some carpenters. The county's economy turned sour and the pension fund went broke. What do you say to those folks?

That was an Economically Targeted Investment. What do you say to the workers, the young ones, the ones that were already retired, the folks like Mr. Manzullo's father? What do you say to those people?

Mr. Schulder. A very bad outcome and a bad choice by the fiduciaries in that fund. There are risks always in these things, but again we have got risks throughout American capitalism. Some things fail, some things gain.

There is nothing inherently, however, more risky in ETIs, as has been demonstrated here today -- enforce the law, make sure the law -- that the trustees, in fact, are doing their job and don't let them get away with risky investments. If you can show they are risky investments *per se* because of ETI kinds of characteristics, let's put them out of business.

Representative Saxton. Okay.

Well, listen, thank you all very much for being here. We appreciate your participation, and we look forward to hearing more about this subject as our bill is considered by the House of Representatives.

Thank you very much.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

PREPARED STATEMENT OF JIM SAXTON, VICE CHAIRMAN

The purpose of this hearing is to discuss Economically Targeted Investments, or ETIs. As Congress struggles to downsize government, President Clinton is working behind the scenes to expand government's reach and use private pensions to finance his liberal social agenda. In the investment world, this practice is known as "social investing." The Administration has dubbed these social projects "Economically Targeted Investments" or ETIs, but I prefer to call them PTIs or "Politically Targeted Investments."

Today, millions of hardworking Americans contribute significant sums of money to their pension plans. Each week they look at their pay-stub and see how much money they have contributed to their pension. These millions of hardworking Americans expect their contributions to be there when they retire. They expect the pension trustees to invest their money with prudence and loyalty.

Last week I introduced the Pension Plan Protection Act of 1995 to prevent the practice of ETIs.

It is important to note that something over $3.5 trillion are in private pension funds today. This is the amount of investment wealth that have been put at risk by the Clinton Administration advocacy of ETIs.

Faced with an angry revolt of voters last November against too much Federal spending, President Clinton and his Department of Labor are trying to use private pensions to accomplish what they can no longer do through old fashioned taxing-and-spend programs. These ambitious social planners now want to use private pensions to finance investments such as: Public housing, infrastructure, and pork-barrel projects.

Let me emphasize that targeting private pension fund investments is a radical and dangerous idea. ETIs violate the clear mandate of the Federal law that Congress passed to protect private pensions -- the Employee Retirement Income Security Act, commonly referred to as ERISA.

Let me quote directly from ERISA: A pension fund manager must "discharge his duties with respect to a plan solely in the interest of their beneficiaries and for the exclusive purpose of (I) providing benefits to participants and their beneficiaries; and (II) defraying reasonable expenses of administering the plan." ERISA does not say "fiduciaries must

make decisions primarily in the interests of and almost entirely to provide benefits to participants and beneficiaries." It says solely and exclusively! Exactly what parts of "solely" and "exclusively" doesn't the Clinton Labor Department understand?

Besides ETIs obvious conflict with ERISA, the best economic research indicates that pension funds that target social investments produce below market returns.

Just one example will suffice. In 1990 Connecticut made a targeted investment in Colt Manufacturing, paying $25 million for 47% of the company. Colt went bankrupt in 1993, and the pensioners in Connecticut will never see that money again.

Even President Clinton, while Governor of Arkansas, convinced the Arkansas Teachers Retirement System to finance a mortgage for the Kappa Kappa Gamma Sorority House at the University of Arkansas. When the trustee was questioned about this unusual pension investment, he replied, "Why I know all the daddies of those girls, and there is no way they would have let that loan default."

The Clinton Administration's ultimate objective is to establish an ETI quota for every private pension fund. This process is already happening in the states. What Secretary Reich would make permissible today, will become compulsory tomorrow.

Last week I introduced a bill that will protect the 42 million private pension participants from President Clinton's pension fund grab. My bill, the Pension Plan Protection Act of 1995, will not alter the fiduciary duties laid out in ERISA. Instead, my bill will simply reiterate that the act means what is says -- no more, no less.

Every American who plans on retiring someday should be very concerned about what the Clinton Administration is up to. I expect we will hear a lot today about different aspects of this issue but we should not lose sight of one very important fact: The $3.5 trillion in private pension funds was earned by the hard work of millions of Americans, it belongs to them, it should be invested solely to benefit them, and pension managers should be loyal only to them.

PREPARED STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

Good Morning. I would like to congratulate Chairman Saxton for his good work on this critical issue and I am pleased to be the primary sponsor in the Senate of the Pension Protection Act of 1995.

Let me begin by reminding each of us that last November the American people sent a loud and clear mandate for less spending, less taxes, and less government. This morning, however, we are here to examine an on-going effort by the Administration which ignors that mandate. The Department of Labor has developed a disturbing scheme to divert pension assets to fund social and political projects. By relaxing ERISA's strict fiduciary standards, the Department of Labor has found a way around Congress and the budget process to tap a new source of money for their projects. This highly orchestrated effort is designed to expand government and expose our nation's taxpayers and retirees to unnecessary and dangerous consequences.

It is no surprise that this Administration's big spenders are looking to the assets of pension funds while Congress is struggling to balance the budget. Totalling over $3 trillion, they see private pension funds as an attractive source of capital for a variety of social projects. The Clinton Administration has never shied away from its intent to use private pension funds as a convenient source of public funding. In fact, in his book, "Putting People First", President Clinton proposed a $20 billion "investment" program funded by pension funds. Just last Congress, Housing and Urban Development Secretary Henry Cisneros requested over $500 million in taxpayer guarantees to induce pension funds to invest in high-risk low-income housing projects. HUD had no ability to evaluate the risk of this demonstration project yet they wanted a green light to experiment with **over half a billion taxpayers dollars !**

The alarming speed at which the Administration has proceeded with its campaign to promote these social "investments" known as Economically Targeted Investments, or ETIs, combined with the poor record of ETIs across the country, is nothing short of reckless.

There are three basic elements of our nation's retirement income system: the Social Security system, personal savings, and private pensions. When we take into consideration low personal savings rates, the imminent aging of the baby boom population, and the demand that will be placed on the Social Security Trust Funds, now is **not** the time for the Administration to be spearheading efforts which compromise our nation's private pension system. In fact, there already exists considerable anxiety about the solvency of our nation's pension system.

Further exposure of these funds to unnecessary risks could set up the American taxpayer for another savings and loan-style failure and bail-out. The protection of retirement income is, and must continue to be, the overriding objective governing the investment of pension assets.

Efforts directing private pension funds to replace public funding of government programs is yet another example of this Administration's "spend now, pay later" mentality. This Congress is working to put the federal government back on a sound fiscal foundation by balancing the budget and eliminating the deficit. The last thing we should be doing is replacing the fiscal irresponsibility of the past 30 years with another risky and irresponsible policy. We should not compromise fiduciary standards and the financial security of our nation's retirees in order to meet the social and political goals of the Administration.

PREPARED STATEMENT OF PETE STARK, RANKING MINORITY MEMBER

Mr. Chairman, I regret to say that I consider today's hearing a waste of the committee's time and energies. We all know why this hearing is being held. Today the Republicans are passing a budget that will slash programs for America's elderly. Republicans have slated the Medicare portion of Social Security for a $288 billion cut. They also propose a $24 billion cut in Social Security checks. Finally, they plan to cut $187 billion in Medicaid benefits, a third of which go for the elderly. In combination, these three cuts will cost the average elderly person more than $3,500 by the year 2002.

In a desperate attempt to change the subject, the Republicans are staging this hearing with the baseless charge that Clinton Administration pension rules will hurt the elderly. In fact, just as in health care and Social Security, the Clinton Administration is working to defend the elderly:

- The policy to permit economically targeted investments does not cost the elderly one red cent in pension benefits, since the rules require that the risks and returns of ETIs must be the same as for other investments.
- The current interpretation of the law is identical to the policy adopted under previous Presidents, including both President Reagan and President Bush.
- The ERISA rules require that all investments have competitive rates of return and risk but only permit the additional consideration of collateral benefits.

The legislation proposed by Vice Chairman Saxton is not just a solution in search of a non-problem, it is pernicious. It would create a "thought police" for pension fund managers. If two pension fund managers make the same investment in a promising project that turns sour, the manager who can claim he only had- financial considerations in mind has no problem. But, a manager who may have invested not only for the financial returns but also for collateral benefits would be personally liable for losses under the Saxton bill. In effect, the Saxton bill says to fund managers: "Don't let us catch you considering anything that may benefit your country or your fellow citizens. If we catch you thinking about anything but the fund's bottom line, you're in trouble."

What else does the Vice Chairman's bill say to pension managers? It says you can protect yourself by putting your funds in Wall Street but don't even think about putting them in your own community. It says

invest in a multinational that plans to close factories and ship jobs abroad, but don't even think about investing in an American company to help create jobs here. It says invest in a foreign company that will compete with the U.S. but don't even think about using your funds to help an American company compete.

I would like to hear how the Vice Chairman would deal with two programs in New Jersey.

In New Jersey, the State Investment Council directs the investment of about $34 billion of assets for the state public employees pension funds. The following is a statement of the Council's policy toward social investing:

The Council has adopted a favorable official policy regarding "Social Investment." The Council has determined that investing for the benefit of fund beneficiaries need not exclude investments in New Jersey or those which advance other social goals. In 1984 the Council codified a list of Social Investment rules for the State Division of Investment that includes reviewing all reasonable investment proposals presented by New Jersey corporations and giving preference to New Jersey investments if other terms are equal.

Is the Vice Chairman going to go back to New Jersey this weekend and demand that the state pension funds be prohibited from giving preference to New Jersey investments if other terms are equal?

There is another program the Council initiated in 1986:

Under the program, the Division determines a market rate for mortgages once a month and creates an open window to buy identical New Jersey mortgages from banks at this rate. In fiscal year 1992, one million dollars of New Jersey mortgages were purchased. The open window can prevent temporary capital gaps from developing if New Jersey suffers a temporary shortage of secondary mortgage funds.

Is the Vice Chairman going to go home this weekend and demand that the State pension funds stop buying New Jersey mortgages and only purchase mortgages from other states?

I look forward to hearing the witnesses.

TESTIMONY OF OLENA BERG
ASSISTANT SECRETARY OF LABOR
PENSION AND WELFARE BENEFITS ADMINISTRATION
BEFORE THE JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
MAY 18, 1995

Mr. Chairman, members of the Committee. Thank you for inviting me to testify today. I appreciate the opportunity to be a part of your inquiry into Economically Targeted Investments, or ETIs. ETIs are generally defined as investments that provide risk adjusted rates of return to plan participants, as well as collateral benefits such as job generation, affordable housing, revitalization of infrastructure, and small business development. This hearing represents an opportunity to move toward a shared understanding of the issues in this field. By the time you have concluded your inquiry, it is my hope that a good deal of the misinformation that has been circulating on this topic of late will be dispelled. I particularly want to stress that the Clinton Administration has no plans to mandate any form of pension investing, and has no intention of taxing pension funds.

Pension funds in the United States hold over $4.8 trillion in assets. They are an increasingly important force in the allocation of capital in the American economy. As major owners of corporate America, pension plans need to be concerned with the growth and stability of the nation's economy. Pension plans are also a growing source of funds for investments in small

business -- an important source of job creation in this country. Further, as long-term investors, with investment time horizons reaching forty years or more, pension plans need to be concerned that the capital is made available that will allow these small businesses to grow into the Fortune 500 companies of the future. We believe that investing in our future is a goal worth advancing for the benefit of American workers and their families.

The Clinton Administration is committed to the protection of workers' financial security in retirement, as provided under the Employee Retirement Income Security Act of 1974 (ERISA), the federal pension law. In fact, the Administration and Congress strengthened federal protections of pension plans last year by approving the Retirement Protection Act. Again, in response to two pieces of misinformation, I would like to state as forcefully as I am able that the Administration never has and does not intend to mandate pension investment in any category of investment. Similarly, the Administration never has, nor does it intend to tax pension fund income. My primary mission, as the Assistant Secretary of Labor for Pension and Welfare Benefits, is to protect workers' pensions. I would never advocate a policy that I believed would put pension benefits at risk.

For many years now -- going back at least as far as President Ronald Reagan's first term -- pension plan fiduciaries have been

approaching the Labor Department with a question. Does ERISA allow a plan fiduciary to choose among alternative investments by considering facts aside from the financial contribution of those investments to the plan in making an investment decision?

The answer that the Labor Department has given -- again, since President Reagan's first term -- is that ERISA does allow the consideration of other factors in choosing between investments of equal attractiveness to the plan, but does not allow consideration of such factors if the investment is not equally attractive to the plan as alternative investments. For at least 15 years, the Department has made it clear that pension plan fiduciaries may generally use their own discretion in determining how they will choose from among multiple investment opportunities that have competitive risk adjusted rates of return. One of the touchstones of ERISA is the flexibility it gives plan fiduciaries in making investment decisions on behalf of plan participants.

One of ERISA's overriding principles is to assure that private pension funds are managed solely for the exclusive purpose of providing benefits to participants and beneficiaries of the plan. ERISA requires pension fund investment managers and trustees to invest prudently and for the exclusive benefit of the plans' participants. For this reason, investment in ETIs meets ERISA's requirements so long as the investment has a projected

20-518 O - 96 - 3

rate of return comparable to alternative investments with similar levels of risk. A pension plan's managers must first, foremost, and always, evaluate available investment opportunities exclusively in terms of their financial attractiveness to the plan. This requires an assessment of their expected risk-adjusted rate of return, as well as other factors, such as the plan's needs for diversification and liquidity.

There should be no doubt in the minds of fiduciaries as to their absolute obligation to satisfy all of ERISA's fiduciary requirements on every investment made with pension funds, including investments in ETIs. The law requires it; the Administration is sworn to uphold it; and we at the Labor Department are committed to bringing the full force of law against pension plan fiduciaries who compromise that obligation.

Now, while two or more investment opportunities may be comparable in terms of their risk-adjusted rate of return, there may nevertheless be other considerations that may make one such investment opportunity more likely to serve the interests of the plan's participants than the others. A fiduciary might make the judgment, for example, that one of the available, competitive and appropriate plan investments, more so than the others, would fill a key need for the plan, such as providing capital for small businesses in a region where the plan sponsor is located. All other things being equal, that investment could be a more

attractive choice for the plan and its participants. Investment in small business could improve the local economy or provide needed services, thereby creating a collateral benefit to participants and beneficiaries. Whether it be jobs, housing, or small business investment, it is this strategy that has come to be called "economically targeted investing." However, for such an investment to be allowable under ERISA, all other things must be equal for the ETI as compared to other investments available to the plan.

Over the years, pension plan fiduciaries have asked the Department for guidance on the legal standing of the ETI concept. The Department also received a report on this issue from its Advisory Council on Employee Welfare and Pension Benefit Plans, known as the ERISA Advisory Council, a 15-member bipartisan group of nationally recognized benefits experts. The 1993 Council, consisting of members appointed during the Bush Administration, conducted deliberations on this issue for more than a year, receiving extensive testimony at public hearings. As a result of this study, the Council recommended that "[t]he Department should issue an advisory opinion or other formal document affirming its current position on ETI programs," which is summarized as allowing "pension plans to favor ETIs once such assets meet a prevailing rate test based strictly on their financial characteristics." In response to this recommendation, the Department issued Interpretive Bulletin 94-1 on ETIs on June 23,

1994. This document brought together the previous statements made by the Department on this subject; these documents are attached, and we ask that they be made part of the record of this hearing.

Now, this is a point on which I want to be very clear. Labor Department Interpretive Bulletin 94-1 did no more than consolidate and reiterate the Department's past guidance in this area. These previous statements include the attached twenty-three documents issued during both Democratic and Republican administrations.

Despite the long stability of ERISA and its gratifying success in protecting retirees, a number of claims have been offered in an effort to justify legislation to amend that statute. One insinuation is that the Administration really intends to impose the ETI strategy upon all pension plans by federal mandate. There is simply no truth to this claim.

As I have stated previously, and as the Interpretive Bulletin we've issued clearly shows, this Administration's interpretation of the fiduciary rules of ERISA has not departed in any way from the settled interpretation that has been applied since the law's enactment 20 years ago. That interpretation clearly allows the use of an ETI strategy, as it allows any other investment strategy, in the discretion of each plan's fiduciaries

provided that the investments are made in compliance with ERISA's fiduciary rules. In my own speeches and presentations on this subject, many of them published, I have repeatedly stated that the use of the ETI approach is entirely up to the discretion of plan fiduciaries. We went on record yet again in our published response to the recent General Accounting Office report on the use of ETIs by public sector pension plans, expressing our unequivocal agreement with the GAO's opinion that a pension plan's use of an ETI program should be strictly voluntary.

Consistency with Previous Statements of Policy

Top Labor Department officials spanning the administrations from Presidents Carter through Bush have written letters regarding the use of ETIs by pension funds. Ian Lanoff, who served as the head of the Department's ERISA enforcement program under both Presidents Carter and Reagan, has stated in his letter the following: "...it is my opinion that the ERISA legal standards contained in Interpretive Bulletin No. 94-1, as they would apply to economically targeted investments ("ETIs"), are exactly the same as the ERISA legal standards which have been employed by the U.S. Labor Department since the late 1970s when I served as ERISA Administrator at the Department." Mr. Lanoff's successor, Robert Monks, provides similar confirmation in his own letter: "In my opinion, Interpretive Bulletin 94-1 sets forth a policy that is consistent with the policies announced by DOL during the years that I had principal responsibility for the

ERISA program.... In my view, DOL's policies requiring investments be made for the 'sole' purpose of benefiting plan participants are unchanging and inveterate."

Dennis M. Kass, my predecessor under the Reagan Administration, stated in 1986, "[t]he view that non-economic benefits may be achieved incident to the proper investment of pension funds is one of long standing under both the Internal Revenue Code prior to the passage of ERISA and under ERISA. Clearly, to prohibit such benefits where the provisions of the law have been scrupulously adhered to would unnecessarily constrain fiduciaries in the exercise of their investment duties. Such a prohibition could result in specific investment opportunities being avoided by fiduciaries simply in order to avoid the possibility of an incidental benefit arising from them."

David George Ball, my immediate predecessor, stated before the American Institute of Certified Public Accountants in December 1992 that, "[i]t is the Department's long standing position that non-economic factors cannot be allowed to take precedence over providing retirement income to participants and beneficiaries. Plan fiduciaries must consider the merits of each investment and determine whether the investment provides a rate of return commensurate with the financial risk involved. Non-economic factors may only be considered in making investment

decisions if they do not compromise the economic balance of risk and return to the plan and are consistent with ERISA's diversification and other requirements."

Marshall Breger, Solicitor of Labor under President Bush, stated before the Commission to Promote Investment in America's Infrastructure, "[a]s the chief legal officer of the Department of Labor, I can tell you that nothing in ERISA's fiduciary provisions specifically prevents a pension plan from investing in infrastructure facilities [a common type of ETI]. But like any other pension plan investment, it has to be done right."

It is important in understanding this issue to resolve a question on which there must be no doubt. To do that, let me describe an idea, or viewpoint, that has been favored in some circles in years past. It is the belief that pension plans should be equally as concerned with the nation's social problems as they are with their responsibility to provide retirement income for the retirees who depend on them. Some advocates of this view maintain that pension plans should be prepared to make compromises in the way they invest, sacrificing competitive rates of financial return in favor of lower-yielding investments that would serve some perceived social end.

Now, if I communicate nothing else to you today, let it be this: the Clinton Administration does <u>not</u> support this view. To

the contrary, we are unequivocally and unalterably opposed to it. I want to state this as clearly and forcefully as I can, in order to put to rest any misunderstandings on this point once and for all. This Administration is opposed to any pension fund investment practice that would subordinate the plan's interest in securing the appropriate risk adjusted rate of return to another purpose, be it social gains or anything else. It is clear to us, as it should be to everyone, that any policy or practice that would compromise the ability of pension plans to pay benefits to retired workers is wrong.

It goes without saying that no investment is without some risk. Indeed, it is for assuming that risk that investors are compensated. The listing of a handful of losing ETIs, therefore, when the GAO and others have documented many successful economically targeted investments, tells the thoughtful inquirer very little. Indeed, if these losing investments represent the sum total of all losses incurred by ETIs, then surely the ETI concept must be among the most successful investment strategies ever devised. ETIs are like any other investment vehicle, they can earn or lose. For example, there are bull days and bear days on the stock market and real estate can increase in value or go belly up.

Recently, several studies that purport to show that ETIs are somehow associated with lower overall investment returns have

been put forward. None of these have gone so far as to establish any causality. They are all, in my view, fundamentally flawed in a variety of other respects as well. At most, they examine three years of investment returns, an insufficient period of time given the business cycle. The one study using a five year period found no association at all between ETI use and poor returns. They have used only rudimentary methods of risk adjusting returns and therefore the results they do show may be due to many other factors. The results have, in every case, been extremely marginal in terms of the statistical validity of their findings, producing results that would not be considered significant by most rigorous standards. In comparison, GAO conducted studies in 1992 and 1995, that surveyed the performance of hundreds of ETIs over a period long enough to be statistically reliable, and came to the conclusion that ETIs are a viable, legitimate investment from an income-producing perspective.

You are no doubt aware of recent pronouncements prescribing the "correct" interpretation of ERISA's fiduciary provisions, and asserting that the Labor Department has strayed dangerously from the true path. However, as noted above, these claims are sharply at odds with the conclusions of your research and investigative arm, the GAO. In addition, an independent, comprehensive 50-state study sponsored by the Small Business Administration confirmed, in February 1995, that ETIs targeting small business can provide rates of return comparable to those offered by

similar, non-ETI investments.

Statutory and Case Law Background

ERISA § 403(c)(1) provides that, with certain exceptions, the assets of the plan shall be held for the exclusive purposes of providing benefits to participants in the plan and the beneficiaries and defraying reasonable expenses of administering the plan. ERISA § 404(a)(1)(A) provides that, subject to certain other provisions, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to the participants and their beneficiaries and defraying reasonable expenses of administering the plan. These provisions are essentially a codification of the trustee's duty of undivided loyalty to trust beneficiaries under the common law of trusts. See Eaves v. Penn, 587 F.2d 453, 457 (10th Cir. 1978)

In Donovan v. Bierwirth, 680 F.2d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982), the court held that fiduciaries may take actions that benefit the interests of a corporate employer if they reasonably conclude, after conducting a prudent inquiry, that the action is in the best interest of the plan. The fiduciary determination to take this action must be made with an "eye single" to the interest of the plan's participants and beneficiaries. Id. at 271. Other courts have also adopted the position that a fiduciary's action, if otherwise prudent and

taken in the best interest of the plans, does not violate ERISA because it creates an incidental benefit to someone else. Trenton v. Scott Paper Co., 832 F.2d 806, 809 (3d Cir. 1987), cert. denied, 485 U.S. 1022 (1988); Donovan v. Walton, 609 F. Supp. 1221, 1245-46 (S.D. Fla. 1985), aff'd sub nom Brock v. Walton, 794 F.2d 586 (11th Cir. 1986).

The structure of Title I essentially compels the above interpretation. ERISA §§ 406 and 407 prohibits broad classes of transactions between plans and persons having pre-existing relationships with them. Section 408 provides a catalogue of statutory exemptions from these prohibitions for certain types of transactions as well as a procedure for the Department to grant administrative exemptions. The Department has always made clear that the exemptions of section 408, both statutory and administrative, do not provide relief from the requirements of section 403 or 404. If ERISA were interpreted to state that the exclusive purpose requirements of ERISA were per se violated by a plan entering into a transaction that requires a section 408 exemption because it provides an incidental benefit to a party in interest, the exemptions would be ineffectual and a trap for the unwary.

ERISA's exclusive purpose requirements are related to a similar requirement in the Internal Revenue Code (IRC). Section 401(a) of the IRC requires that trusts forming part of a pension

plan be "for the exclusive purpose of [the employer's] employees and their beneficiaries." Section 401(a)(2) also requires that the instruments of such trusts make it impossible for any part of the corpus or income of the trust to be "used for, or diverted to, purposes other than for the exclusive benefit of [the employer's] employees or their beneficiaries."

These provisions pre-date ERISA, and in 1969, the IRS issued Revenue Ruling 69-494, 1969-2 C.B. 88., which states in pertinent part:

> The primary purpose of benefitting employees or their beneficiaries must be maintained with respect to investments of the trust funds as well as with respect to other activities of the trust. This requirement, however, does not prevent others from also deriving some benefit from a transaction with the trust.[1]

The revenue ruling, which specifically involved employer stock, sets forth four requisites applicable for investments to meet the exclusive benefit standard under section 401(a) of the Code:

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

The ERISA Conference Report, in discussing the prudence standard,

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[1] This revenue ruling restates and supersedes the position of that agency as expressed in a Pension Trust Service Ruling (PS No. 49) issued on June 6, 1945.

referred to the above-cited Code requirements and revenue ruling. H.R. Rep. No. 93-1280, 93d Cong., 2nd Sess., at 302 (1974). The report states:

> Under the Internal Revenue Code, qualified retirement plans must be for the exclusive benefit of the employees and their beneficiaries. Follcwing this requirement, the Internal Revenue Service has developed general rules that govern the investment of plan assets, including a requirement that cost must not exceed fair market value, that at the time of purchase, there must be a fair return commensurate with the prevailing rate, sufficient liquidity must be maintained to permit distributions, and the safeguards and diversity that a prudent investor would adhere to must be present. The conferees intend that to the extent that a fiduciary meets the prudent man rule of the labor provisions, he will be deemed to meet these aspects of the exclusive benefit requirements under the Internal Revenue Code.[2]

Similarly, in several advisory opinions and other letters issued over the period from 1980 to 1993, the Department has taken the position that a fiduciary can choose, on the basis of non-financial considerations, between two alternatives that were financially equally advantageous to the plan. See Letters collected in the preamble to Interpretive Bulletin 94-1, 59 Fed. Reg. 32606 n. 2. In one example of such a letter, the Department has said that a fiduciary may not be influenced by a desire to stimulate the construction industry and generate employment,

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[2] Although section 9343 of OBRA '87 provides that titles I and IV of ERISA generally are not applicable in interpreting the Code, the IRS approach to the exclusive benefit requirement, as shown above, continues to be generally consistent with the Department's approach to the exclusive purpose requirement in title I of ERISA. See Gen. Couns. Mem. 39870 (Apr. 7, 1992). When a trust fails to conform to the exclusive benefit requirements of IRC § 401(a), it fails to qualify for tax exempt status. Winger's Department Store, Inc., 82 T.C. 869 (1984)

unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to the alternative investments available to the plan. See letter from the Department to Theodore Groom, dated Jan. 16, 1981, attached, which we ask to be made part of the record.

As noted above, on June 23, 1994, the Department issued an Interpretive Bulletin which, in summary, stated that the requirements of ERISA §§ 403 and 404 do not prevent plan fiduciaries from investing plan assets in an ETI if the ETI has an expected rate of return that is commensurate with rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan. 59 Fed. Reg. 32606.

Genesis of the ETI Clearinghouse

Prudent investment requires that the investor understand the risk and return characteristics of the investment. The clearinghouse for ETIs for which the Department has undertaken to provide seed capital is designed to provide this type of information to pension funds.

By way of background, in 1992 the Department's ERISA Advisory Council under the Bush Administration unanimously

recommended that the Department "take the initiative" in collecting information on ETIs and distributing this data to pension funds and other interested parties. Expanding on this recommendation, the 1993 Council evaluated the concept of establishing a clearinghouse on ETIs to collect and distribute information on ETIs. This group recommended that

> "the Department of Labor take a leadership role in designing the structure of an ETI clearinghouse or network and committing start-up capital to permit such an entity to compile and analyze data, with its continued operation and maintenance to be under the auspices of a private, non-profit organization."

We followed this recommendation by issuing a Request for Proposals last April to solicit bids for the contract to run the clearinghouse. After careful review of contract bids, in September of 1994 we awarded the contract to Hamilton Security Advisory Services, Inc., a Washington, D.C.-based financial and investment consulting firm. Hamilton's Executive Director is Austin Fitts, a former senior housing official in the Bush Administration, and the Deputy Director is Grace Morgan, a former aide to Senator Alfonse D'Amato of New York. In keeping with the Council's recommended "leadership role," I have made clear in public statements and official correspondence on this matter that the fact that an investment opportunity is listed on the clearinghouse does not mean that it is endorsed by the Department, and does not mean that it is an appropriate investment for the plan. Of course, an investment opportunity that is not listed may also be appropriate for the plan, provided always that it satisfies ERISA's standards. Plan fiduciaries

still have the obligation to perform all analyses that are necessary to convince themselves that a particular investment would be appropriate. They are not freed of any of their fiduciary obligations.

Hamilton's data collection survey materials were reviewed and approved by the Office of Management and Budget in late March of this year, and Hamilton is finalizing the software necessary to collect and access this information obtained on ETIs from pension funds. Finally, Hamilton is also reviewing candidates for its advisory board representing a diverse array of interests, including the investment and financial communities, public and private pension funds, organized labor and the participant community.

Conclusion

One final point needs emphasis: this Administration does not, would not, and never will mandate the use of ETIs. Any suggestion to the contrary is simply wrong. We believe that it is up to pension plans to find investments which will earn the best risk adjusted returns, and if those investments also generate benefits which will help the economy, that's fine. After all, nothing increases the financial strength of a pension plan like a sound economy.

For over twenty years, the Department of Labor has been a

custodian of ERISA, and the guardian of the interests of plan participants. Pension funds have grown remarkably during this period and are a major source of financial strength and flexibility in the economy. We are committed to preserving the rigorous fiduciary standards that Congress established as part of ERISA and will oppose any tampering with these well established and proven standards.

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TESTIMONY OF

CHARLES E. ROUNDS, JR.

BEFORE

THE UNITED STATES JOINT ECONOMIC COMMITTEE

IN OPPOSITION TO ETIs

May 18, 1995

My name is Charles E. Rounds, Jr... Mr. Chairman...Members of the Committee. I am a Professor of Law at Suffolk University Law School in Boston and co-author of the 7th Edition of Loring: A Trustee's Handbook (Little, Brown & Co.-1994). The Handbook will have its one hundredth anniversary in 1998. I am pleased to testify in opposition to the Clinton Administration's policy of encouraging private employee benefit fund managers to invest in Economically Targeted Investments (ETIs). I wish to make one fundamental point:

> **Secretary Reich's ETI policy interferes with the private property rights of working Americans by undermining the fundamental duty of trustees to act soley in the interest of their beneficiaries.**

Since 1976, the common law trust has been the focus of my teaching, writing, and practice. Prof. Maitland considered the trust--a refinement in the concept of **private** property--to be the greatest achievement of English juriprudence[1]. So do I.

It is because I am convinced that a number of initiatives of the Clinton Administration...the **Clinton Deficit Reduction Trust Fund**...the **Violent Crime Reduction Trust Fund**...the **Presidential Legal Expense Trust**...and perhaps most troublesome of all,

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[1]Rounds & Hayes, Loring: A Trustee's Handbook, pg 1 (1994)

Secretary Reich's ERISA regulatory bulletin encouraging private fund managers to invest in **ETIs**...assault the very institution of the private trust, that I come before you today[2]. There are real world consequences to all of this that extend beyond the ivory tower. **In the case of Secretary Reich's ETI policy, for example, the undermining of a trustee's fundamental duty of loyalty threatens not only the institution of the trust but the nest eggs of millions of working Americans, the life savings of real people.**

A trust is a fiduciary relationship with respect to property[3]. The trustee has the title to the property[4]. The trustee, however, has a duty to deal with the property for the benefit of another[5]. In trust parlance, that other person is called the beneficiary.

With the exception of insured plans, the assets of private employee benefit plans are held in private common law trusts[6]. Thus the worker who participates in a private qualified employee benefit plan is a trust beneficiary. As such, under the common law, and under ERISA[7], he is entitled to the trustee's **undivided loyalty**. Secretary Reich's ETI policy erodes that fundamental duty. The Restatement of Trusts is unambiguous in this regard:

> In administering the trust the trustee is under a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishement of the purposes of the trust. Thus, it is improper for the trustee to purchase property for the trust ... for the purpose of advancing an objective other than the purposes of the trust[8].

It is settled law that a worker's interest in a private

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[2] See generally Rounds, Will the Institution of the Trust Survive the Clinton Presidency?, 25 the Advocate 31 (Spring 1995) attached hereto.

[3] Restatement (Second) of Trusts §2 (1959)

[4] Id.

[5] Id.

[6] 29 USCA §1103 (ERISA)

[7] 29 U.S.C.A §1104 (ERISA)

[8] Restatement (Third) of Trusts §170, Comment q.

employee benefit trust is an item of private property'. It belongs to the worker. Not to the trustee, not to the employer, not to the taxpayer, not to Secretary Reich, not to President Clinton, not to the members of this committee. It belongs to the worker. **When Secretary Reich plays with a trustee's fundamental duty of loyalty, he is playing with the personal assets of workers and their families.**

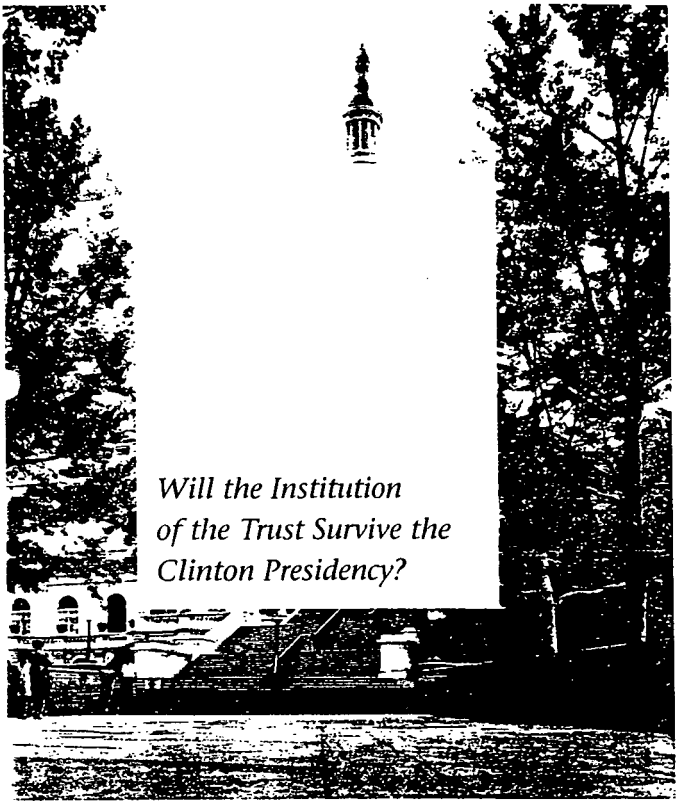
Moreover, this aggregation of private wealth has a difficult enough and important enough social mission, namely to provide private economic support to those workers and those families, in other words to real human beings. It does not need the additional burden of having to participate in Secretary Reich's risky social experiments. Suffice it to say, that to the extent economic value actually gets sucked out of our **private** pension system as a result of **public** political initiatives such as ETIs, someone will have to absorb the resulting economic loss, be it the worker, the employer's stockholder, or the taxpayer. Wealth does not exist in a vacuum.

This concludes my opening remarks.

' 1 Restatement of Property at 3 (1936) (Introduction to Chapter 1); see also 1 Restatement of Property §§ 1-5, §6, comment a; see generally Rounds & Hayes, Loring A Trustee's Handbook §§ 3.5.1, 5.1, 5.3.2, 5.4.1 (1994); see also, Restatement (Second) of Trusts §130 (1959).

Trusts in the National News

By Professor Charles E. Rounds, Jr.



On November 16, 1994 in the Pallot Library, Professor Charles E. Rounds, Jr. concluded the Law Library Speaker Series for 1994 with a lecture on how the common law trust has become the subject of political exploitation at the national level. The following is the text of Prof. Rounds's lecture for those of our readers who were unable to attend the Speaker Series.

Professor Maitland considered the common law trust — a refinement in the concept of *private* property — to be the greatest achievement of English jurisprudence, the "largest and most important of equity's exploits." The public instinctively understands this and bestows on the institution, as well as the office of trustee, its respect and its trust. It believes the trust to have almost magical properties capable of warding off all manner of unpleasantness. "Put it into a trust and everything will be alright." This store of private sector good will, carefully cultivated over the centuries by enlightened judiciaries and scrupulous fiduciaries, has not gone unnoticed by our politicians and others in the discredited *public* sector. They have discovered that merely by employing the language of the private trust, they can plunder its good will and further the cause of the regulatory state all at the same time. We have here a politician's dream.

The store was first broken into in the 1930's with the so-called *Social Security Trust Fund*. Despite the term "trust," the social security system contains nothing that remotely resembles the common law trust. There is no segregation of assets, no equitable property rights, no private right of enforcement[1] (all characteristics of the common law trust). It is merely a system of taxation and appropriation sprinkled with trust terms to hide its true nature. Since then a number of other bogus trusts have found their way into the Internal Revenue Code.[2] In the last year or so, however, the process of abusing the trust vocabulary has gathered a good head of steam. We now have the *Clinton Deficit Reduction Trust Fund*, the *Violent Crime Reduction Trust Fund*, and a related outrage, the *Presidential Legal Expense Trust*. The first two are trusts only in name. The last is a trust in form but not in substance. Each is designed to tap the good will of the private trust in order to fool the public into doing something that it would not otherwise do. Such sowings of semantic confusion cannot but further erode an institution already under assault in the halls of academia.[3]

Clinton Deficit Reduction Trust Fund

The Clinton Deficit Reduction Trust Fund has none of the elements of a common law trust. In particular it contains no "property" — segregated or otherwise — nor does the thing impose any enforceable duties on anyone. It is essentially an accounting gimmick dreamed up by Senator DeConcini (D-Ariz.) to provide political cover for his support of the President's budget. The President obliged on August 4, 1993 by issuing Executive Order 12858 purporting to "guarantee" that the net deficit reduction achieved by the Omnibus Budget Reconciliation Act (OBRA) of 1993 be dedicated to reducing the deficit. Each year, "amounts" are to to be "credited" to the fund on a daily basis equal to the net deficit reduction achieved by OBRA. The order purports to "require" that the "fund balances" be used exclusively to redeem maturing debt obligations of the Treasury held by foreign governments. In other words, there is no build up of property, only credit entries. Thus there is nothing in the arrangement that would prevent the Treasury from creating debt to pay off debt that it must pay off in any case. Nothing is segregated, nothing is guaranteed, and nothing is to happen that will not happen in any case with or without the order. The Clinton Deficit Reduction Trust Fund is a complete and utter sham.

The store was first broken into in the 1930's with the so-called Social Security Trust Fund. Despite the term "trust," the social security system contains nothing that remotely resembles the common law trust.

We now have the Clinton Deficit Reduction Trust Fund, the Violent Crime Reduction Trust Fund and a related outrage, the Presidential Legal Expense Trust. The first two are trusts only in name. The last is a trust in form but not substance.

Violent Crime Reduction Trust Fund

The recently enacted Federal "crime bill" makes provision for the establishment of a "crime reduction" trust to be funded with "savings" derived from reducing the federal workforce by 272,900. No provision is made, however, for segregating out and investing the compensation that would have been paid to these phantom employees so that, once again, we have a trust neither in form nor in substance.

Presidential Legal Expense Trust

On June 28, 1994, President and Mrs. Clinton, transferred $2,000 in trust to John Brademas, Michael H. Cardozo, Theodore M. Hesburgh, Barbara Jordan, Nicholas de B. Katzenbach, Ronald Olson, Elliot Richardson, Michael Sovern, and John Whitehead. The 10 page trust indenture, drafted by M. Bernard Aidinoff, Esq., of Sullivan & Cromwell, provides that the trustees shall solicit additional contributions from U.S. citizens who are not Federal employees. The fund, as augmented, shall then be used to reimburse the President and Mrs. Clinton (the grantors) for their "personal legal fees and related expenses incurred after January 20, 1993." The instrument limits individual gifts to $1,000 per year. While Federal employees are excluded by its terms from participating in this scheme, there is no such exclusion for lobbyists.

A careful review of the governing document reveals some interesting features. The Clintons have the unrestricted right to hire and fire the trustees; to appoint themselves as trustees; and, together with the trustees, to amend or revoke the trust. In other words it is a garden variety, fully revocable living trust. Moreover, upon accomplishment of the trust's purpose (which can change at any time at the whim of the Clintons) the fund shall pass outright and free of trust to the Clintons or the survivor of them. If they both die before termination, the estate of the last to die gets the windfall. The income earned on the fund is fully taxable to the Clintons. A "contribution" is not tax deductible; it is, however, eligible for the Federal gift tax exclusion.

There is an attachment to the trust document which also makes interesting reading. It is a non-binding letter, dated June 28, 1994, from President and Mrs. Clinton to the trustees:

> "...This letter will confirm *our respective intentions* (emphasis added), if any part of the corpus is paid over to either of us or our personal representative, to donate any such surplus to one or more non-profit institutions or the United States Government, without claiming any incidental income tax deductions for ourselves or our estates."

When all is said and done, the whole thing is nothing more than a scheme for generating unrestricted

personal gifts to the President and his wife. The format of the trust has been employed to create an illusion of respectability and accountability. On September 4, 1994, Judicial Watch, Inc. filed an action in the U.S. District Court for the District of Columbia[4] alleging among other things that "persons donating money to the Trust, the Trustees, and those acting in concert with the Trustees,...do so with the expectation that they will receive in return influence, political favors or something of equal value from the executive branch, the President and/or Mrs. Clinton." The Plaintiff alleges that the arrangement is in violation of numerous Federal statutes including the Federal Advisory Committee Act, 5 U.S.C. App 2 and seeks among other things that the "donations" be returned to the donors. Since the filing, the National Legal and Policy Center has joined Judicial Watch, Inc. as a plaintiff.

Economically Targeted Investments ("ETIs")

But the administration is not only abusing the institution of the trust by sowing semantic confusion, it is also proposing to tap into the economic value itself of the nation's $3.6 trillion system of private pension trusts which, unlike the Social Security System, is financially and actuarially sound. In the 1992 campaign piece "Putting People First: A National Economic Strategy", candidate Clinton called for the creation of a "Rebuild America Fund" with a $20 billion Federal "investment" annually for five years, leveraged in part with private pension funds. Revenues from road tolls, solid waste disposal fees and public housing rents would "guarantee" a return from such investments (known as "economically targeted investments" or ETIs). Labor Secretary Reich has issued an ERISA regulatory bulletin "encouraging" fund managers to invest in ETIs.

Rep. Jim Saxton (R-N.J.), in a September 29, 1994 *Wall Street Journal* opinion piece, suggested that ETIs were really PTIs — politically targeted investments — and that the track record for such investments in the public sector has been dismal. In the late 1980's, for example, the Kansas Public Employees Retirement System had to write off about $200 million in ETI investments. Out of Alaska, Connecticut, and Missouri have come similar horror stories. According to Rep. Saxton, "[n]ot all ETIs have been disastrous, but most have yielded subpar results." The Saxton opinion piece evoked an outraged response from Secretary Reich. In an October 26, 1994 letter to the *Wall Street Journal*, Reich asserted that investing in ETIs would not not amount to "social investing." He then proceeded to undermine his own assertion:

> "As owners of a considerable portion of America's capital markets — with more than $4.8 trillion in assets — pension funds depend on the success of not only their investments, but of the entire economy. By making investments that increase the economy's capacity to lift living standards, pension funds bolster the current prospects of workers — and therefore the retirement income security of those who participate in pension plans.

Is the Clinton/Reich ETI scheme a step in the direction of social securitizing the national system of private pension trusts? That is a subject beyond the scope of this lecture. Suffice it to say that to the extent economic value is actually sucked out of a system for public political initiatives, as happened in Kansas, someone absorbs the resulting economic loss, be it the employee, the employer's stock holders, or the taxpayer (or some combination of the three). Wealth does not exist in a vacuum.

Any socialization or nationalization of the wealth in the national private pension system would be an unfortunate turn of events. Enormous additional patronage and political power would accrue to the Secretary of Labor in his capacity as the system's ERISA mandated regulator. The institution of the common law private trust, of course, would take yet another hit. And then there is the human component to the fundamental legal relationship that is the trust. The workers' beneficial or equitable interests in their pension trusts are private property interests. It is *their* property; it belongs to *them*, not to Secretary Reich or President Clinton. This wealth has a difficult enough and important enough social mission, namely to provide *private* economic support to retirees and their families. It does not need the additional burden of having to participate in Secretary Reich's social experiments.

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[1] *See generally Flemming v Nestor*, 363 U.S. 603, 80 S. Ct. 1367 (1960).

[2] *See generally* Rounds & Hayes, *Loring A Trustee's Handbook* § 9.6.3 (1994).

[3] As of April 15, 1994, the Harvard Law School had no one to teach an elective course on wills and trusts. *Harvard Law Record*, April 15, 1994, pg. 1, col. 2.

[4] Case Number 1:94CV01688 (Lamberth)

May 18, 1995

Statement of Professor John H. Langbein
Yale Law School

Thank you for allowing me a hearing on the important question of preventing the politicization of pension fund investing.

Background. I am a scholar and teacher of pension law and trust law. My law school coursebook on pension and employee benefit law is used in most American law schools that teach the course (J. Langbein & B. Wolk, Pension and Employee Benefit Law, Foundation Press, 2d ed. 1995). I serve as a Uniform Law Commissioner from Connecticut. I chair the national Commission's Trust Division, and I worked as the reporter and principal drafter of the Uniform Prudent Investor Act (1994). I have written extensively about the dangers of so-called social investing for two decades.

The dangers of social investing. Attached to my statement is an essay that I wrote a few years ago: Social Investing of Pension Funds and University Endowments: Unprincipled, Futile, and Illegal, from the volume Disinvestment: Is It Legal, Is It Moral, Is It Productive? (Washington 1985). The essay summarizes the main arguments that comprise the case against social investing.

In the decade since I wrote that paper, little has changed on the merits. The political causes have changed. South Africa and the Soviet Union are no longer prime targets. We are now experiencing a new wave of pressure for localism in investing, supposedly in the name of job creation. And new causes will be advanced in the future. The dangers of politicized investment remain the same, and I have explained them in the essay.

Beware the ETI label. Although the game is the same, the label has changed in some quarters. We now hear less about social investing, and more about "economically targeted investments" (ETIs). Whoever coined this label deserves the P.T. Barnum Prize for Deceptive Repackaging.

The well-established critique of social investing is that, for a variety of legal and practical reasons, it is wrong to invest for political reasons in ways that are likely to impair the economic return to the pension fund. Calling politically motivated investments "ETIs," hence hinting that there is something "economic" about this uneconomic behavior, is misleading Newspeak.

ERISA's triumph. The proposal currently before the Congress is to tighten ERISA, and I support it, but before getting there, I think we need to pause and recognize what a success story ERISA has been in this field. ERISA § 404 articulates the main

standards (loyalty and prudence) that prevent the worst forms of social investing. Furthermore, the Department of Labor (DoL) has generally enforced these standards in a responsible way. Thus, most of the horror stories of social investing have occurred in state and local plans that are exempt from ERISA under ERISA § 4(b). What's left to be done?

Costlessness. The main weakness in the law as DoL has interpreted it is that ERISA fiduciaries are allowed to consider noneconomic criteria, hence social and political causes, when doing so is "costless." It's OK for a plan fiduciary to take account of political or other noneconomic objectives when the fiduciary determines that pursuing such goals in the investment process is economically costless to the pension fund.

This rubric, developed under DoL's well-meaning pension chief in the Carter Administration, Ian Lanoff, has been successful in eliminating the worst abuses, but it is still dangerous to pension funds and their beneficiaries.

The "costlessness" rubric is beguiling. If social investing schemes were really costless, it would be hard to object to them. The problem is that these schemes are not costless. Rather, the costs are hidden. Costlessness is too easy to fudge in cases such as mortgage lending and investing in troubled local firms. The reason is that real estate and close corporation interests

are unique and hard to value. Unlike shares of AT&T or the Vanguard Index Trust, most social investing projects (that is, most ETIs) lack a market price. You cannot look up a price for these deals in the Wall Street Journal. They lack just that comparability that is needed to demonstrate that the investment was indeed costly to the pension fund.

By allowing supposedly costless social investing, DoL creates an incentive for politically-minded fiduciary investors to play politics with pension funds and hide the costs. Take, for example, that recurrent script: the union-dominated multi-employer plan in one of the construction trades wants to raid the pension fund in order to prop up the job market for construction workers (or at least, to prop up the jobs of construction workers with the most union seniority; these ETIs are often barely designed schemes by which the savings of younger workers get turned over to old union hands).

What happens in this case is that the politically-motivated fiduciary investor "papers" the file. He makes a few calls, gets some inflated numbers for supposedly competing investments. Then he recites into his file why the ETI is costless. If the investment goes sour, it is very hard for the victims (or the DoL enforcement people) to come along after the fact and unpack the deceit.

Now contrast our long tradition in trust investment law (which is the great wellspring from which we derived our pension fiduciary law). In trust law, we prohibit self-dealing and we prohibit avoidable conflicts of interest. We have an absolute prophylactic rule. When we catch a trustee engaged in self-dealing, our law takes the firm position that it is not interested in whether the self-dealing behavior was fair to the beneficiaries of the trust fund. The law imposes liability for self-dealing without more. Self-dealing is per se breach of trust. See Restatement of Trusts (Second) § 170(1) (1959). The reason for the rule is that we know how hopeless it often will be to figure out after the fact whether a disloyal transaction was fair.

That same rationale should apply to social investing schemes, to ETIs. Social investing schemes, ETIs are disloyal. By definition they are not undertaken for the exclusive benefit of the pension plan beneficiaries. These schemes are undertaken for the supposed benefit of others--South African workers, the American union movement, dolphins, and so forth. "Costlessness" is in truth just supposed fairness by another name. For the reasons that we have decided that we cannot police fairness in trust law proper, we should not be attempting to police costlessness in pension trust law. The dangers to pension plan beneficiaries are enormous. The difficulty of detecting corruption and political abuse of workers' savings is grave. The

simple solution is to prohibit political and other noneconomic considerations from pension investing.

Remember, once pension plan beneficiaries receive their distributions, they can be as socially conscious and politically active with their money as they choose. All we are asking is that plan managers be prevented from playing politics (and playing favorites) with their members' money.

The hidden issue in social investing is, who gets to decide on whether to support social causes, and if so, which ones? By forbidding social investing and ETIs, we maximize the amount of investment income that will flow through to the plan beneficiaries, who can use their retirement income in support of whatever causes they prefer. The hidden agenda in social investing is capture--pressuring plan fiduciaries to invest in support of political and social causes that many plan beneficiaries would not wish to support.

Forbidding social investing and ETIs would thus protect the workers and retirees in two ways. It would maximize the economic return on their investments. And it would free them from the threat of the capture movements that dominate social investing discourse, allowing each individual plan beneficiary to select those social and political causes that he or she cares to support.

TEXT OUTLINE

SOCIAL INVESTING OF PENSION FUNDS AND UNIVERSITY ENDOWMENTS: UNPRINCIPLED, FUTILE, AND ILLEGAL*

by

JOHN H. LANGBEIN**

Interest groups of various sorts have been campaigning in recent years to politicize the criteria that govern the investment of pension funds and university endowments. These funds should not, say the various campaigners, be invested in companies that do business in South Africa, or that have resisted labor union demands, or that manufacture munitions, or that pollute. Another strand of the social investing movement is localism; particularly as regards the pension funds of state and local government employees, there is pressure to invest for the purpose of stimulating the local economies.

This article is concerned to explain why the traditions of trust law, pension law, and the law of charity rightly forbid social investing. I shall direct primary attention to pension funds, whose enormous size and importance has made them the main target of the various social-investing pressure groups. In the final section of this paper (Part VII), however, I point to legal factors that make social investing objectionable for university and other charitable endowments.

I. UNDERSTANDING THE RISE OF PRIVATE PENSION FUNDS

At year-end 1983 the one thousand largest nonfederal pension plans in the United States had assets of $806 billion.[1] Total pension-fund assets exceed a trillion dollars.[2] These staggering sums reveal that a very large fraction of personal savings and of aggregate capital formation in the United States occurs through the medium of pension plans.

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[1]Pensions & Investments Age, Jan. 23, 1984, at 3.
[2]Id., Apr. 18, 1983, at 10.

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*Portions of this article, especially Parts VI and VII, are based upon material previously published in John H. Langbein & Richard A. Posner, Social Investing and the Law of Trusts, 79 Michigan Law Review 72 (1980). Posner subsequently became a federal appellate judge and has taken no part in the preparation of the present essay.

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Huge demographic shifts underlie this phenomenon. People are living longer, thanks to many factors, of which the twentieth-century revolution in health care (above all, the discovery and refinement of antibiotics) is the most important. In consequence, the gap between the time we cease to work and the time we die is widening. For that interval in our lives, we need a source of income other than current employment—we need what has come to be called "retirement income." In former times the retirement income gap tended for most people to be small or nonexistent, and transfers within the family tended to cover the gap. The elderly lived with their children and they did not live long. To the extent that private savings were insufficient, children were expected to help. But family structure has changed under the impact of urbanization, population mobility, and longevity. People have fewer children. Children leave their parents when they marry, and the elderly often find themselves living at great remove from their children. Furthermore, with increased longevity comes the problem of decrepitude in advanced old age. The increasing need for care of the elderly tends ever more to be met by specialized providers, both because of their expertise, and because the children of the elderly, especially when living in modern dual-wage-earner families, are ever less able to render such care at home.

As late as the early decades of the twentieth century neither government nor private industry seemed much concerned with the retirement income problem. Individuals were left to their own devices—private savings and intrafamilial arrangements. A few employers began to sponsor pension plans as early as the last quarter of the nineteenth century,[3] but the great movement to organize saving for retirement through employer-sponsored plans did not get underway until World War II and thereafter.[4]

The Great Depression struck at a time when many of the demographic changes that caused the retirement income problem were as yet recent. Many elderly people had not fully appreciated the implications of these changes; they had not (and perhaps could not have) made adequate provision through savings. The Social Security program was devised in the 1930s both to provide immediate relief to the destitute elderly of the day, and to guarantee retirement income to future retirees.

The defects of Social Security were long concealed, although they are now widely understood. Social Security is a transfer program rather than a savings plan. Present workers are taxed to pay retirement benefits to present retirees. Today's present workers pay taxes in the expectation that future workers will be taxed to pay benefits when the present workers retire. But because of changes in birth rates and longevity, the workforce is declining in proportion to the number of retirees. Accordingly, the burden of financing the transfers has grown enormously. The prospect looms that tomor-

[3]See, e.g., William C. Greenough & Francis P. King, Pension Plans and Public Policy (New York, 1976) 27ff; William Graebner, A History of Retirement: The Meaning and Function of an American Institution (New Haven, 1980).

[4]Alica H. Munnell, The Economics of Private Pensions (Washington, D.C. 1982) 10ff.

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row's smaller cohort of workers cannot be taxed enough to pay comparable retirement benefits to today's workers. The sense that Social Security cannot play as large a part in the retirement income of future retirees as it does for those today is one of the most important factors in the explosive growth of the private pension system.

The experience with Social Security has also left us an important lesson about the dangers of exposing the retirement income system to the winds of electoral politics. Successive Congresses sweetened current benefits and eligibility requirements with scant regard to the implications for future retirees. Only the most recent financial crises within the Social Security system have slowed that process. Further, Social Security has had devastating effects upon the economy. There is strong evidence for the view that, by promising substantial future income flows without requiring either individuals or the state to save enough to fund those obligations, Social Security has played the key role in the worrisome decline in American savings rates and capital formation.[5]

Only against this background can we fully appreciate the importance of the private pension system. The retirement income problem will become ever more acute: there are more retirees and they are living longer. Ever larger income flows must be generated to support them. Meanwhile, the financial contradictions of Social Security have put it under a cloud from which it will never fully emerge. The long process of lowering popular expectations about Social Security is well underway. The future of the retirement income system lies, therefore, in the private sector.[6]

II. HOW PENSION FUNDS WORK[7]

The variety of pension plan types and features is large and complex. The details can baffle almost anyone, sometimes even the professionals (accountants, actuaries, lawyers, plan administrators) who specialize in the field. Fortunately, in order to understand the main issues in the social investing debate, it will suffice to describe only some basic distinctions and characteristics.

Funding. The great difference between a modern private pension plan and a transfer system such as Social Security is that private plans are funded. Savings are set aside regularly during the employee's working career. This money is invested, and the investment yield (often called the "build-up") accumulates along with the savings. When the employee re-

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[5]See, e.g., Martin S. Feldstein, Social Security, Induced Retirement and Aggregate Capital Formation, 82 Journal of Political Economy 902 (1974).

[6]But see Dennis E. Logue, How Social Security May Undermine the Private Industrial Pension System, in Financing Social Security (Colin D. Campbell, ed.) (Washington, D.C. 1979) 265.

[7]See generally, Dan M. McGill, Fundamentals of Private Pensions, 5th ed., (Homewood, Ill., 1984).

tires, the fund is used to support him (and, under most plans, to support his spouse as well) until death.

Taxation. Federal tax policy has encouraged the private pension movement, especially since the 1940's. The employer is allowed to deduct his contributions to a qualified pension plan immediately, even though the employee does not actually receive the money until he retires.[8] Further, the build-up is exempt from taxation during the period of accumulation;[9] only when the employee begins to receive retirement income from the plan is he taxed on what he receives. Taxation is thereby postponed. Since most people find themselves in lower tax brackets when they retire (retirement income usually being somewhat less than employment income), postponement has the further effect of reducing the amount of taxes for most people.

The Protective Policy. These tax concessions reflect a consensus that has been endorsed repeatedly in tax and other federal pension legislation. The policy is protective. Private pension plans are encouraged for fear that people would not, acting individually, save enough to meet their retirement income needs. The tax concessions are meant to induce employers and employees to allocate a larger share of compensation away from current wages and into retirement savings.

The protective policy is manifested elsewhere in pension law, apart from the tax code. Federal law imposes a "spendthrift" provision on most pension funds, preventing an employee or his creditors from alienating (and thereby consuming) pension savings before he retires.[10] Likewise, federal law forbids the employee from waiving his right to have his pension fund invested prudently.[11] The protective policy has been, although not the only policy, surely the centerpiece of pension taxation and pension regulation. It will be seen that the protective policy bears importantly on the question of whether an employee has the power to endorse social-investing proposals that may impair his retirement income security.

The Trust Form. Pension funds typically take the form of a trust. The trust relationship is one of the most highly developed categories of the Anglo-American legal tradition. Thus, although the private pension fund is a relatively young phenomenon, it rests upon a familiar juridical basis.

Trust-investment law, now enforced by special pension legislation, supplies the rules that regulate the investment of pension assets; we shall see that this body of law takes the harshest view of investment activities that are not undertaken for the exclusive purpose of maximizing the economic well-being of trust beneficiaries.

Contributory or Not. Many plans are funded entirely from employer contributions. Because there is no deduction from the employee's pay-

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[8]Internal Revenue Code [hereafter cited as I.R.C.] sec. 404.

[9]I.R.C. sec. 402.

[10]I.R.C. sec. 401 (a)(13).

[11]Employee Retirement Income Security Act [hereafter cited as ERISA] secs. 404 (a)(1)(D), 409, 29 U.S.C. secs. 1104(a)(1)(D), 1109.

check, such plans are called "noncontributory"—the employee does not contribute. By contrast, "contributory" plans are those that require the employee to devote some fraction of gross pay—say, five percent—to the plan. Typically, the employer matches the employee's contribution according to some formula, for example, one-to-one or two-to-one.

This distinction between plans to which the employee contributes and those to which he does not would seem to be important, but in economic terms it is not. Because even the employer-paid component of a pension plan is a cost of employment, it is best understood as a part of the wage packet, hence a form of involuntary savings whose true cost is borne by the employee. Both the employer-paid and the employee-paid contributions derive from what is—in economic terms—the employee's wages. Translating this point into traditional trust-law terms, we may say that the employee is in an important sense the "settlor" of his own pension trust.

Defined Contribution and Defined Benefit. Broadly speaking, there are two basic types of pension plans, defined contribution and defined benefit plans. A defined contribution plan is best analogized to a savings account. The plan calls for the establishment of a separate account for each employee. Contributions are credited to the account at a rate specified in the plan, and the account participates proportionately in the investment gains of the plan. When the employee retires, the size of his pension will depend entirely upon the size of his account. Ordinarily, the plan calls for the account to be annuitized and distributed over the remainder of his life (or, in the event of a joint annuity with his spouse, over the remainder of their two lives). The college and university teachers' plan, TIAA-CREF, is the best-known defined contribution plan. IRA and Keogh accounts work on the same principle.

A defined benefit plan, by contrast, is one in which the employer (or other plan sponsor) promises to pay a retirement benefit according to a plan formula—for example, sixty percent of average salary over the last five years of the employee's service. The employer makes regular contributions to the plan, in accord with acturarial projections of the sums needed to fund the promised pension levels.

Defined contribution and defined benefit plans allocate investment risk oppositely. Under a defined contribution plan, it is the individual employee who bears the burden of disappointing investment results or who enjoys the gains from exceptionally good results. Under a defined benefit plan, the employer bears the investment risk; since the employer has promised to provide benefits of a certain level, the employer remains liable to pay the benefits even if the fund turns up short.

Multiemployer Plans. Most pension plans are so-called "single-employer" plans—General Motors has a plan for its employees, IBM for its. In some industries, however, where employment patterns are episodic (the construction trades, entertainment, trucking, the needle trades, and a variety of others) individual companies do not sponsor pension plans. Rather,

groups of employers sponsor a common plan, mostly in response to collective bargaining with a labor union. Although the Taft-Hartley Act requires equal numbers of management and union trustees on the board of such a plan,[12] in practice union interests tend to prevail, and these plans are often spoken of as union plans.

ERISA. Like most substantial fields of finance, pension plans have attracted government regulation. The federal tax concessions have been conditioned on various regulatory requirements since the 1940's. In 1974 Congress greatly extended the scope of federal regulation when it passed the Employee Retirement Income Security Act (ERISA). ERISA limits forfeiture of benefits under pension plans (through the so-called "vesting" rules); it imposes minimum eligibility and funding standards; it narrows the range of plan discretion in the design of benefit-accrual schemes; and it imposes fiduciary rules for the investment of plan assets.[13] Title IV of ERISA introduced a federal insurance scheme, ostensibly patterned on FDIC insurance for bank deposits, that guarantees most benefits under defined benefit plans against shortfall or default.[14] By making the federal government the pension paymaster of last resort, Title IV creates a further public interest in the financial soundness of the investment practices of private pension plans.

Compulsory Trusteeship. ERISA requires that pension plan assets be placed in trust,[15] and ERISA refines and codifies traditional trust-investment law for the pension field.[16] These provisions further the protective policy of pension law. Pension trustees are financial intermediaries who specialize in investing pension funds. Trusteeship removes investment decisions into the hands of professionals and prevents plan participants (most of whom are inexperienced in matters of high finance) from doing their own investing. Thus, while I am free to be foolish in investing my personal savings, my pension savings will necessarily be invested according to the professional standards of the investment industry.

Preemption. From the standpoint of the social-investing movement, one of ERISA's most important provisions is what lawyers call a preemption clause: ERISA expressly supersedes state law for most pension plans.[17] By federalizing pension law—including pension-investment law—in this way, ERISA has greatly narrowed the scope for social-investing initiatives beneath the level of federal law. If, for example, the Missouri legislature were to enact a social-investing measure requiring the pension plans of Missouri firms to invest their funds in Missouri mortgages, the courts would quickly invalidate the statute for violation of ERISA's preemption rule.

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[12]Labor Management Relations Act sec. 302(c)(5), 29 U.S.C. sec. 186 (c)(5).

[13]ERISA secs. 201 et seq., 301 et seq., 401 et seq., 29 U.S.C. secs. 1051 et seq., 1081 et seq., 1101 et seq.

[14]ERISA secs. 4001 et seq., 29 U.S.C. secs. 1301 et seq.

[15]ERISA sec. 403, 29 U.S.C. 1103

[16]ERISA secs. 404 et seq., 29 U.S.C. secs. 1104 et seq.

[17]ERISA sec. 514(a), 29 U.S.C. sec. 1144(a).

State and Local Plans. States, municipalities, school districts, and various other public bodies operate pension plans for their employees. These governmental plans are exempt from the requirements of ERISA,[18] which is a main reason why social-investing proposals have so often been directed at them. State and local plans differ from private plans and among themselves in matters of structure and governance. Often a state board, sometimes attached to the state treasurer, is responsible for those investment and administrative functions that would be performed by trustees for most private plans.[19]

Like Social Security, most state and local plans are run by bodies that possess taxing powers. As with Social Security, the temptation has been felt to leave future taxpayers to pay the retirement benefits for today's public workers, even though the entitlement to those benefits accrues presently and should be regarded as a cost of current employment. Thus, whereas Social Security is virtually entirely unfunded and is almost a pure transfer scheme, the state and local plans tend to be partially funded. There is some current saving and investment, but not enough to meet future obligations.

III. THE HIDDEN DYNAMIC IN SOCIAL INVESTING

The elderly are, as a group, neither affluent nor politically adventurous. Why, then, is the social investing movement aimed so resolutely at the pension funds that exist to support the elderly? Why do the proponents of social investing treat pension funds as being especially appropriate to bear the costs of an investment strategy that sacrifices financial for political interests?

Social investing could in principle be attempted by any investor, not just pension trustees. There are three small mutual funds which proclaim adherence to various social principles in selecting their investments.[20] If an individual decides to invest in such a fund, presumably he has balanced the possible financial costs of such a policy against the personal satisfaction that he derives from supporting the social aims implied by the fund's investment policy. Few individuals have found these funds attractive. Another indication that most investors disagree with most social investing campaigns is that shareholder initiatives in support of the main social investing causes are invariably defeated by margins of 95 percent or worse. Furthermore, there has been little pressure on trustees of individual trusts to adopt social

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[18]ERISA sec. 4(b)(1), 29 U.S.C. sec. 1003 (b)(1).

[19]See Marcia G. Murphy, Regulating Public Employee Retirement Systems for Portfolio Efficiency, 67 Minnesota Law Review 211 (1982).

[20]These are Foursquare, Dreyfus Third Century, and Pax World. Foursquare avoids liquor, tobacco, and drug company stocks. According to its prospectus, Third Century limits itself to companies "contributing to the enhancement of the quality of life," whatever that means. Pax World excludes any company more than five percent of whose sales are to the Defense Department. See Pacey, Investment Do-Gooders: A Look at a Dogged Trio of Socially Conscious Mutual Funds, Barron's, Jul. 21, 1980, at 9.

investing. The main purpose of the typical individual trust is to generate income for the immediate support of the current beneficiary, who would be strongly inclined to protest if the trustee adopted an inconsistent goal. Many trust intruments authorize the beneficiary or the settlor to change trustees, and such a provison tends to concentrate a trustee's mind wonderfully on profit maximization.

Social investing proposals are directed at pension funds not in order to further the interest of the pensioners, but in disregard of their interests. It is the separation of ownership and control characteristic of pension-fund structure that social-investing proponents find so enticing. Vast sums of money are invested for—but not by—the concerned individuals. That separation, we have seen, exists in large measure to protect present and future retirees against the tendency that some might have to undersave for retirement, or to invest unwisely. But by concentrating the pension savings of tens of millions of people in the hands of a few thousand pension trustees, our private pension system has created a pressure point that would not otherwise have existed. Ironically, therefore, the separation of ownership and control that was meant to protect pension plan beneficiaries has also exposed them to a new danger—that pressure groups may politicize the process of investing their pension savings.

The hidden dynamic in the social investing movement is this effort to take advantage of the separation between ownership and control of pension savings. The pension trustees who control pension investment work under the constraints of trust-investment law. The proponents of social investing understand that by reinterpreting trust-investment law to permit politicized investment they could capture pension savings for their causes.

But why should the proponents employ such a surreptitious strategy, pressuring pension trustees, when a more forthright path lies open? Why not pursue political causes in the political arena? It is vital to understand that, almost by definition, the causes that are grouped under the social-investing banner are *those that have failed to win assent in the political and legislative process*. Congress has the power to mandate all the well-known social-investing causes: forbid American firms to do business with South Africa; require American firms to cease making munitions, or to have unionized work forces; require pension assets to be invested locally; and so forth. Federal legislation could accomplish any of these goals. For example, present federal law applies to Cuba exactly the sort of prohibitions on commerce and lending that opponents of the South African regime have sought without success in recent years from both Democratic and Republican administrations. The reason, therefore, that the proponents of social investing are bullying pension trustees is that they have been unable to get their political programs accepted in the political process.

IV. PRINCIPLES OR POLITICS?

Are there principles of social investing that a trustee can follow with ease? If not, then social investing is standardless, a mere label used to clothe pressure-group demands. If social investing is intrinsically standardless, adherence to it will expose pension trustees to a perpetual wave of political demands.

Consider, therefore, the question of investing in firms that do business in or with South Africa. It is important to understand that there is no controversy about the racial policies of South Africa. People on all sides of the matter have equal disdain for apartheid. But there is broad disdain in the United States for many other regimes. The hard question that proponents have not answered is this: Why is the campaign for divestiture directed almost entirely at South Africa, and not at such monstrously objectionable regimes as Libya or Soviet Russia? South Africa is a place in which 80 percent of the inhabitants are denied political and civil rights that Americans regard as basic. But there are many regimes in which 99 percent of the inhabitants are in this position.

In 1978 Yale University's Committee on South Africa Investments tried to duck this question in a report that said: "We acknowledge the possibility that the policies of other governments throughout the world are equally antagonistic to the basic principles of American society and this University; if so, then our recommendations concerning South African investments should be applied to them."[21] It is not a possibility that there are other such societies; it is a certainty. (At the time that the Ad Hoc Committee wrote its report, the Amin regime was still in power in Uganda and the Pol Pot regime in Cambodia.) What the Committee seems to be saying, if one reads between the lines, is that it will not consider further applications of the social-investing concept until some group raises as great a stink as the opponents of the South African regime have raised. This approach makes social investing a branch of interest-group politics.

In truth, there can be no consensus about which social principles to pursue and about which investments are consistent or inconsistent with those principles. At a time when most of the social activism in investing was liberal or radical rather than conservative, there was some agreement among the activists as to the types of companies that should be avoided and the types that should be embraced. The ranks of the disapproved included companies doing business with South Africa, big defense contractors, non-union companies, and companies that polluted the environment. With the

[21] Yale University, Ad Hoc Committee on South Africa Investments, Report to the Corporation 4 (Apr. 14, 1978).

rapid rise of social activism on the political right, we can expect social-investing advocates to appear who will urge investment managers not to invest in corporations that manufacture contraceptive devices, or publish textbooks that teach the theory of evolution, or do business with Russia.[22]

There is also increasing awareness that the criteria used to identify socially irresponsible companies are dubious even if the ultimate objective—say, pressuring South Africa—is accepted. An American corporation that has a plant in South Africa where it creates jobs, provides training, and engages in collective bargaining with a black union is not obviously contributing more to the perpetuation of apartheid than an American corporation that, without having an office in South Africa, manufactures goods that find their way to South Africa. As the New York Times reported in September of 1984, "[a] survey among black South African factory workers" established their "overwhelming resistance to disinvestment by American firms."[23]

The Massachusetts legislature has lately supplied us with a splendid illustration of the truth that social investing is nothing more than pressure politics. In a recent statute the legislature singled out, in addition to South Africa, one other country for the disapprobation of the state pension fund: Great Britain. Not Libya or Russia; not Iran, Cambodia or Syria, whose regimes have recently massacred tens of thousands of their dissident citizens; but Britain, mother of parliaments and closest great-power ally of the United States. Why? Oh, nothing serious, just a little gratuitous intermeddling in the difficult Northern Irish situation, for the entertainment of the Boston Irish. (The Massachusetts statute is reproduced below in footnote.)[24]

If we move beyond foreign affairs and examine other social-investing causes, we find a similar lack of principle. In labor union circles it has become fashionable to decry pension-fund investment in companies whose work forces have rejected labor unions, but that complaint overlooks important distinctions. For example, which unions? Some American labor unions are clean and are devoted to their members, but others are dominated by organized crime. Is it really "anti-social" to resist a latter-day Jimmy Hoffa? And what of the right *not* to join a labor union? The elaborate election and certification procedures for union representation under federal law presuppose that Congress meant to protect both the right to join and the right to

[22]See John M. Leger, Business Links with Soviets under Attack, Wall Street Journal, Mar. 26, 1981, at 23, col. 3.

[23]Alan Cowell, Blacks in a Poll Dispute Apartheid Foes' Tactic, N.Y. Times, Sept. 23, 1984, at 10, Col. 5.

[24]Annotated Laws of Massachusetts, Cumulative Supplement, Ch. 32, sec. 23 (1)(d)(iii): [N]o public pension funds under this subsection shall remain invested in any bank or financial institution which directly or through any subsidiary has outstanding loans to any individual or corporation engaged in the manufacture, distribution or sale of firearms, munitions, including rubber or plastic bullets, tear gas, armored vehicles or military air craft for use or development in any activity in Northern Ireland, and no assets shall remain invested in the stocks, securities or other obligations of any such company so engaged.

abstain from union membership. Equating unionization with social rectitude thus flies in the face of federal law. Nor would compulsory unionization satisfy all proponents of this branch of social investing, since some have demanded disinvestment in firms, however fully unionized, that invest abroad ("export jobs").[25]

Every social-investing cause can be subjected to a similar analysis. How much pollution is too much? Every time somebody goes to the toilet there is increased pollution. The question is not whether there shall be pollution, but how much, of what forms, in what places, subject to what controls, and so forth. The world is not divided into evil polluters and saintly nonpolluters. A vast body of regulatory law and private law exists to draw these difficult lines, and the blunt instrument of social investing has nothing to contribute to it.

Another form of social investing closely associated with labor union pressure is the effort to use pension funds to create jobs—for example, making mortgage loans from the carpenters' pension fund in order to stimulate employment in the construction trades. If the loans were to be made at market rates of interest, there would be no increase in aggregate mortgage lending or in employment, on account of routine substitution effects (described in Part V below, treating the economic flaws of social investing). Thus, the major effort has been to get the pension fund to lend at below-market rates. This would indeed increase construction and thus stimulate some employment in the industry.

The objection to bargain-rate lending is that it is unprincipled in the sense that it violates the primary policies of pension law. By reducing the financial return to the pension fund, bargain-rate lending necessarily sacrifices future retirement income. For present workers it involves just that trade-off of retirement-for-preretirement income that pension plans were created to guard against. But the objection runs deeper: the benefits and the costs affect different people and in different proportions. In particular, pensioners who are already retired and who depend upon the pension fund for current retirement income would derive no benefit from subsidizing employment for current workers. We shall see in Part VI that trust-investment law (and now ERISA) make it flatly illegal to sacrifice the interests of plan beneficiaries in this way.

The root fallacy behind these proposals, which is repeated incessantly in their rhetoric,[26] is that unions have the right to use *their* pension plans to promote *their* interests. But, of course, the plans are not theirs. The plans exist for the exclusive purpose of providing retirement income for the elderly. For the same reason that pension funds cannot be used to defray union organizing expenses or union officers' salaries, they cannot be used to

[25]This last suggestion appears in Ruttenberg, Friedman, Kilgallon, Gutchess & Associates, Inc., AFL-CIO Pension Fund Investment Study (Wash., D.C., Aug. 20, 1980) 57.

[26]E.g., Jeremy Rifkin & Randy Barber, The North Will Rise Again: Pensions, Politics and Power in the 1980s (Boston, 1978).

subsidize employment for union workers at the expense of retirement income for present and future retirees.

The most persistent of the social investing causes is also the most transparently ignoble—the protectionist crusade for in-state investing of state and local pension funds ("Michigan pension money should not be exported to Indiana"). But that phenomenon is better examined from another standpoint, in Part V, treating the economic futility of social investing.

To summarize: There is not and can never be a consensus about what causes are socially worthy. Consequently, a pension trustee who sought to adhere to the criteria of social investing would have no means of identifying the causes to which he had committed the fund. Since there are no principles, every cause entangles the fund in a political struggle. Social investing would impose upon the fund the turmoil and administrative costs of perpetual politicization of the investment function. But a pension trustee has no business making political choices for his beneficiaries; his job is to further the retirement-income security of his beneficiaries, and to leave them to participate in the political process on their own.

V. THE ECONOMICS OF SOCIAL INVESTING

From the standpoint of economic analysis, two fundamental flaws impair virtually all social investing proposals. First, most are futile. Powerful and well-understood economic forces would counteract most social investing strategies, rendering them hollow gestures. Second, social investing has costs—economic disadvantages that harm the interest of pension-plan beneficiaries. We shall see (below in Part VI) that these economic flaws bear vitally upon the legal standards that govern pension-fund investment.

Substitution. Capital markets (the markets where companies and countries seek to obtain a share of the available savings) are intensely competitive. Capital flows to users who offer the highest returns, adjusted for risk. The capital markets are also increasingly international, as recent experience with Middle Eastern petrodollars, Continental eurodollars, and Latin American debtors has underlined.

The competitive nature of the capital markets complicates many social investing strategies to the point of impossibility. That point has long been made regarding the campaign for divestiture of the shares of companies doing business with South Africa. The object of the campaign is to starve the South African economy of capital. Although it is unlikely that economic stagnation would really help rather than hurt the oppressed peoples of South Africa, it is even less likely that social investing would have any material effect upon the South African economy. Pension money is by no means the only source of investment capital; nor are American firms and lenders the only actors. To the extent that social-investing pressures succeed in limiting capital flows to South Africa from some American firms, that simply creates opportunities for other American firms and for foreign firms. In

global financial terms, the South Afrcian economy is miniscule and its external capital requirements correspondingly small. International enterprises and lenders abound who are free from the pressures of the American lobby that concerns itself with this cause. Thus, the campaign to affect the South African economy has had and will have no demonstrable effect.

An incidental indication that the campaign against South Africa is ineffectual is that nobody has bothered to invoke the doctrine of constitutional preemption, in order to have the federal courts declare unconstitutional the various state statutes and city ordinances that direct the respective state and local pension funds to divest South Africa-tinged holdings. These enactments impinge upon the federal monopoly over foreign relations, reaffirmed by the Supreme Court in 1968 in *Zschernig v. Miller*. In that case the court forbad "an intrusion by [a] state into the field of foreign affairs which the Constitution entrusts to the President and the Congress."[27]

In a study published recently in the *New England Economic Review*, the distinguished pension economist Alica Munnell (of the Federal Reserve Bank of Boston) has pointed to the substitution effects that make economic nonsense of the campaign for in-state mortgage lending. Some state pension plans have been purporting to promote in-state construction activity by buying packages of federally insured GNMA mortgages that originate entirely within the state (as opposed to conventional packages that contain mortgages originating in all parts of the country). Since the federal insurance eliminates the risk of default, the regional underdiversification of these packages is unimportant. Munnell concludes that the increasing purchase of these instruments by state and local pension plans has "not increased the supply of mortgage funds . . . ."[28] Rather, a pair of utterly predictable substitution effects are occurring. First, as pension funds increase their buying of these mortgage backed securities, they simply displace other institutional purchasers such as insurance companies, who shift their investing toward the government and corporate bonds that the pension funds were previously buying.[29] Second, the attempt to stimulate in-state construction by purchasing in-state packages (so-called "targeting") appears to be equally futile, and for the same reason.

> Whereas in the absence of the recent targeting rage, a state such as Massachusetts would buy GNMAs backed by mortgages from a number of states, such as Alabama, California, Pennsylvania, etc., now Massachusetts insists on GNMAs backed by Massachusetts mortgages, Alabama on Alabama mortgages, California on California mortages, Pennsylvania on Pennsylvania mortgages, etc. As long as the state's demand for mortgages is roughly proportional to the size of its pension fund, the developing trend of targeting

[27]389 U.S. 429, 432 (1968).

[28]Alicia H. Munnell, The Pitfalls of Social Investing: The Case of Public Pensions and Housing, New England Economic Review (Sept./Oct. 1983) 20, 22.

[29]Id. at 27-28.

> GNMAs should have no impact on the supply of mortgage credit among states.
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> In summary, while social investing through the purchase of targeted GNMAs produces market returns and thereby has no adverse impact on public pensions, this approach is also unlikely to increase either the aggregate supply of mortgage funds or the supply of mortgage credit within a particular state. This assessment has been generally recognized by financial experts. In fact, those who are less than enthusiastic about social investing often push the purchase of targeted GNMAs as a means of satisfying the pressure on fund managers to pursue socially oriented objectives.[30]

The largest claim for this form of social investing is, therefore, that it may deceive people into thinking that it alters investments outcomes, whereas in fact it results in no net increase in construction or in employment. We must emphasize that the reason these "targeted" portfolios of in-state GNMA mortgages are harmless to the pension funds that buy them is that they contain market-rate rather than below-market loans; and that the government guarantee against default eliminates what would otherwise be a menacing degree of underdiversification. Munnell has pointed out that other vehicles used by state pension plans to invest in in-state mortgages have lacked the federal guarantee and in some cases have entailed below-market lending. Under a Connecticut scheme, for example, she found that "the rates at which the mortgages have been offered has varied substantially to slightly below market. As a result, the yield to the pension fund has been well below the GNMA yield that prevailed at the time the funds were committed."[31] In Part VI below I explain that both under the common law rules of trust-investment law and under ERISA, it would be flatly illegal for a pension trustee to sacrifice the financial well-being of plan beneficiaries in this way. (ERISA does not apply to state and local plans.)

Diversification. Over the last quarter-century a great revolution has occurred in scientific understanding of the behavior of capital markets. This revolution in the theory of finance usually goes under the label of modern portfolio theory (MPT) or the theory of efficient markets.[32]

Crudely summarized, MPT has established two central propositions. First, a massive body of empirical investigation has shown that it is extremely difficult (some say impossible) even for investment-industry professionals to achieve long-term results better than the broad market averages, such as (for equities) the Standard & Poor's 500. It seems that capital markets discount new information so rapidly and well that there are few opportunities to outsmart other investors by identifying undervalued securities to buy or overvalued ones to sell.

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[30]Id. at 28.

[31]Id. at 34.

[32]See generally R. Brealey, An Introduction to Risk and Return from Common Stocks, 2d ed. (1983); John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, 1976 American Bar Foundation Research Journal 1.

Second, the capital-market investigators have shown that there are substantial gains to be had from diversifying investments quite extensively. The common law of trusts has long enforced a duty to diversify trust investments, and ERISA codifies that rule.[33] MPT research has given new meaning to the concept of diversification, by showing that in order to eliminate the uncompensated risk of underdiversification, a portfolio must be much larger than previously thought. Optimal diversification requires equity portfolios with hundreds of stocks. Furthermore, these portfolios must be weighted for capitalization, so that large companies such as the oil, auto, computer, chemical, and telecommunications giants are difficult to eliminate from optimally diversified portfolios. The question arises whether social investing, if rigorously pursued, would impair diversification. As more and more social causes are added to the list, the number of companies that are ranked as offenders will become large enough that an optimally diversified portfolio cannot be constructed from the remainder. Social investing would then require the pension plan to bear the costs of the uncompensated risk of inadequate diversification.[34]

The campaign for in-state or localized investing raises especially serious risks of underdiversification. The last thing that workers in declining areas need is to have their retirement savings jeopardized for the supposed benefit of the regional economy. Or suppose that a school board in the vicinity of Mount St. Helens had insisted on investing locally.

The Social-Bargain Fallacy. The claim is sometimes made that social investing is really economically advantageous to pension-plan beneficiaries. For example, companies that do business in South Africa could suffer damage or expropriation from civil war or revolution; companies that resist unionization may incur strikes and boycotts; polluters will get entangled in environmental liabilities; and so forth. Avoiding investment in these firms is, therefore, really a strategy for enhancing the financial well-being of plan beneficiaries by avoiding companies headed for trouble.

This argument is simply another theory of how to beat the market, and like all such theories, it runs afoul of the empirical studies underlying MPT, which strongly imply that consistent market-beating strategies are not to be found. The notion must be that the risks associated with the disfavored companies have not been fully discounted by the securities markets, even though those risks are widely known. But securities markets exist precisely in order to discount such information—that is, to take account of the information in securities prices. Accordingly, all that we know about the behavior of the securities markets suggests that political risk, like any other information that affects future profitability, is fully reflected in current

[33]Restatement of Trusts (Second) [hereafter cited as Restatement] sec. 228 (1957); ERISA sec. 404(a)(1)(C), U.S.C. sec. 1104 (a)(1)(C).

[34]This point is developed in John H. Langbein & Richard A. Posner, Social Investing and the Law of Trusts, 79 Michigan Law Review 72, 88ff (1980).

prices. The indifferent performance of the three small mutual funds that have been following social-investing strategies underscores this point.[35]

To conclude: From the standpoint of economic analysis, there are two types of social-investing outcomes—the futile and the wealth-impairing. The futile are those, such as the in-state GNMA packages, that make no real contribution to the ostensible social goal. The wealth-impairing outcomes lower the return on the fund's savings, or expose it to increased administrative costs, or impose upon it the uncompensated risk of inadequate diversification. We shall now examine the reasons why wealth-impairing social-investing schemes are illegal.

VI. WHY SOCIAL INVESTING IS ILLEGAL

A trustee who sacrifices the beneficiary's financial well-being for any social cause violates both his duty of loyalty to the beneficiary and his duty of prudence in investment.

The Duty of Loyalty. The essence of the trustee's fiduciary relationship is his responsibility to deal with the trust property "for the benefit of"[36] the trust beneficiary. The authoritative *Restatement (Second) of Trusts* says: "The trustee is under a duty to the beneficiary to administer the trust *solely* in the interest of the beneficiary."[37] Although most of the case law applying this duty of loyalty to the beneficiary's interest has arisen in situations of self-dealing or other conflicts of interest in which the courts have acted to prevent the trustee from enriching himself at the expense of the trust beneficiary,[38] the same result has been reached with regard to fiduciary investments for the benefit of a third party (that is, a party other than the trust beneficiary or the trustee). The *Restatement* says, in its Official Comment treating the duty of loyalty: "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of *any* third person."[39] Because the entire object is to protect the trust beneficiary, nothing of principle turns on the identity of the party who profits at the beneficiary's expense.

In the leading case of *Blankenship v. Boyle*,[40] decided in 1971, the duty

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[35]Supra note 20.

[36]Restatement, supra note 33, at sec. 2.

[37]Id. at sec. 170(1)(emphasis added).

[38]See generally 2 Austin W. Scott, The Law of Trusts secs. 170-170.25 (3d ed. 1967 & Supp. 1980).

[39]Restatement, supra note 33, at sec. 170, Comment q (emphasis added). See id. at sec. 187, Comment g (emphasis added):

> The court will control the trustee in the exercise of the power where the acts form an improper even though not a dishonest motive. That is, where he acts from a motive *other than to further the purposes of the trust.* Thus, if the trustee in exercising or failing to exercise a power does so because of spite or prejudice or to further some interest of his own *or of a person other than the beneficiary,* the court will interpose.

For decisional authority see, e.g., Conway v. Emeny, 139 Conn. 612, 96 A.2d 221 (1953).

[40]329 F. Supp. 1089 (D.D.C. 1971).

of loyalty was applied to social investing of pension funds. A multi-employer fund for coal miners that was dominated by the United Mineworkers Union bought large blocks of shares in certain electric utilities in order to induce their managements to buy union-mined coal. On the complaint of some of the pension-fund beneficiaries, the court enjoined "the trustees from operating the Fund in a manner designed in whole or in part to afford collateral advantages to the Union or the [employers]."[41]

ERISA codified the duty of loyalty for pension trusts in its "sole interest" and "exclusive purpose" rules.[42] Section 404(a)(1) provides that the "fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries . . . ."[43] In an essay published in 1980, a pair of Washington lawyers, Ronald Ravikoff and Myron Curzan, attempt to escape this provision of ERISA.[44] I shall devote some space in this article to refuting their essay, both because the essay is misleading, and because it typifies the flimsiness of the legal arguments that are advanced in social-investing circles.

Ravikoff and Curzan correctly observe that ERISA restates the common law duty of loyalty.[45] Accordingly, they reason, since "[t]he purpose of the duty of loyalty is to require a fiduciary to avoid" self-dealing, social investing is unobjectionable "[a]s long as the fiduciary avoids self-interested transactions."[46] But the view that the trustee's duty of loyalty governs only in situations of self-dealing is simply incorrect. To be sure, most people who steal do it for their own gain; that is why most of the case law concerns self-dealing. But the trustee's duty of loyalty exists solely for the protection of the trust beneficiary, and the duty is equally violated whether the trustee breaches for the trustee's enrichment or that of a stranger.[47]

Regarding ERISA's requirement that the fiduciary invest "for the exclusive purpose of . . . providing benefits to participants and their beneficiaries,"[48] Ravikoff and Curzan assert that "[t]he concept of 'benefits' . . . need not be limited to payments that a participant or beneficiary would receive upon retirement, i.e., economic return to an investment. It is arguably broad enough to include numerous types of positive returns, e.g., job security and improved working conditions."[49] This interpretation of the term "benefits" was rejected by the former administrator of the Labor Department's ERISA office, James D. Hutchinson, and a co-author, Charles

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[41]329 F. Supp. at 1113.

[42]See H.R. Rep. No. 533, 93d Cong., 1st Sess. 13, 21, reprinted in [1974] U.S. Code Congressional & Administrative News 4639, 4651, 4659.

[43]ERISA sec. 404(a)(1), 29 U.S.C. sec. 1104 (a)(1).

[44]Ronald B. Ravikoff & Myron P. Curzan, Social Responsibility in Investment and the Prudent Man Rule, 58 California Law Review 518 (1980).

[45]Id. at 531.

[46]Id.

[47]See text at note 39 and note 39.

[48]ERISA sec. 404(a)(1)(A), 29 U.S.C. sec. 1104(a)(1)(A).

[49]Ravikoff & Curzan, supra note 44, at 532.

C. Cole, in an article cited by Ravikoff and Curzan but ignored on the precise question.[50] Hutchinson and Cole point out that ERISA uses the term "benefits" throughout the statute in the more narrow and natural sense "to refer to those cash benefits that a participant or his family would receive in accordance with the specifications of the [retirement] plan."[51] Hutchinson and Cole conclude "that ERISA trusts are to be established and maintained for the limited purpose of providing retirement benefits and 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 associated with the plan."[52]

The New York Teachers' Case. The *Blankenship* case insists uncompromisingly that pension trustees must invest for the purpose of maximizing the financial well-being of the pension beneficiaries. Proponents of social investing seeking to escape the force of that precedent have been tempted to juxtapose a misreading of the 1978 case, *Withers v. Teachers' Retirement System*.[53] In the *Withers* case, retirees who were beneficiaries of the New York City schoolteachers' pension fund, Teachers' Retirement System (TRS), challenged the decision of the TRS trustees to purchase $860 million of New York City bonds as part of the plan that prevented the city from going bankrupt in late 1975. Like most public employee pension funds, TRS had not been fully funded. The main asset of TRS was the city's contractual liability to pay benefits out of future tax revenues calculated on past service. City payments to TRS in the 1974 fiscal year constituted sixty-two percent of TRS's total income (as opposed to nine percent derived from employee contributions and twenty-nine percent from investment income). The TRS trustees testified that although the legal situation was far from certain, their best guess was that in the event of city bankruptcy essential city services and past city bond debt would have priority over payments to

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[50]James D. Hutchinson & Charles G. Cole, Legal Standards Governing Investment of Pension Assets for Social and Political Goals, 128 University of Pennsylvania Law Review 1340 (1980). Ravikoff and Curzan cite the Hutchinson and Cole article as it appeared in Employee Benefit Research Institute, Should Pension Assets Be Managed for Social/Political Purposes? (D. Salisbury, ed.) (Washington, D.C., 1980). See Ravikoff & Curzan, supra note 44, at 531 n. 49. I cite the revised version of the Hutchinson and Cole article that appeared subsequently in the University of Pennsylvania Law Review, supra.

[51]Hutchinson & Cole, supra note 50, at 1370 & 1371 n. 151. The only reason that ERISA is less than explicit in defining "benefits" as a strictly economic term is that no other usage even occurred to the draftsmen. In the Congressional findings that constitute the preamble to the statute the term "benefits" is repeatedly used in the conventional and strictly economic sense. "Congress finds . . . that despite the enormous growth in [pension and other] plans many employees with long years of employment are losing anticipated *retirement benefits* owing to the lack of vesting provisions in 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 the beneficiaries have been deprived of anticipated *benefits* . . ." ERISA sec. 2(a), 29 U.S.C. sec. 1001 (a)(emphasis added).

[52]Hutchinson & Cole, supra note 50, at 1371.

[53]Restatement, supra note 33, at sec. 164(a).

TRS and hence that payments to TRS would cease. In making the loan to the city, the TRS trustees acted in concert with four other municipal-employee pension funds, which agreed to purchase $2.5 billion in city obligations over a two-and-one half-year period.

The court upheld the trustees' action, even though the bonds bore such a high risk of default that they would not have satisfied the normal standards of prudent investing (the purchase was also excessive in amount and would have been in breach of the duty to diversify). Ravikoff and Curzan interpret the court's rationale as follows:

> *Withers* may represent an interpretation of the prudent man rule that is quite different from that set forth in *Blankenship*. *Blankenship* espouses the traditional conception of the rule: a trustee may not select an investment that fosters nontraditional objectives at the expense of adequate rate of return and corpus safety. In contrast, *Withers* appears to permit a fiduciary to compromise these traditional objectives in favor of the other goals—at least to some extent. The court upheld the trustees' investment only because the investment gave much-needed aid to the fund's principal contributor and helped to preserve the jobs of funds participants. That is, the investment was prudent in this case because it provided "other benefits."[54]

In truth, what the *Withers* court did was to point to the host of special factors that made the TRS purchase justifiable under the traditional wealth-maximizing standards of trust-investment law. The court found that the trustee's "major concern" was "protecting what was, according to the information available to them, the major and indispensible source of TRS's funding—the City of New York," and that the trustees "went to great lengths to satisfy themselves of the absence of any reasonable possibility that the City would be able to obtain the needed money from other sources."[55] The trustees used the bond purchase to precipitate federal government financing for New York City, thereby creating for TRS's beneficiaries the prospect of reaching the federal treasury to satisfy the City's liability to TRS. They "obtained a provision conditioning the pension fund's investment in the City bonds on the enactment of federal legislation" providing for interim financing for the City.[56] Indeed, since the trustees' $860 million investment was about what the City would have had to pay TRS over the two-and-a-half year period in question, TRS "could be no worse off under the plan than it would be in bankruptcy without City funds."[57] The court in *Withers* endorsed the *Blankenship* case, and declared that *"neither the protection of the jobs of the City's teachers nor the general public welfare were factors which motivated the trustees in their investment decision.* The extension of aid to the City was simply a means—the only means, in their assessment—to the legitimate end of preventing the exhaus-

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[54]Ravikoff & Curzan, supra note 44, at 523.

[55]Withers v. Teachers' Retirement System. 447 F. Supp. 1248, 1252 (S.D.N.Y. 1978), aff'd. mem. 595 F. 2d 1210 (2d Cir. 1979).

[56]447 F. Supp. at 1253.

[57]447 F. Supp. at 1253.

tion of the assets of the TRS in the interest of all the beneficiaries."[58] The trustees found favor with the court for their effort to protect their greatest asset, which was the liability of the City to pay off its obligations to TRS over future decades.

The Duty of Prudent Investing. Another obligation that trust law imposes on fiduciaries is the duty of care known as the prudent-man or prudent-investor rule. The case law is now effectively codified for pension law in ERISA.[59] The *Restatement of Trusts* words the rule thusly: "In making investments of trust funds the trustee is under a duty to the beneficiary . . . 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 the income to be derived . . . ."[60]

For historical reasons that are widely understood, trust law has placed greater emphasis on risk-avoidance than the modern theory of finance does,[61] but risk and return, however, weighted, are factors exclusively related to the investor's financial well-being. The highly risk-averse investor of traditional trust law accepts a lower return for a lower risk. He does not accept a lower return for some other, nonfinancial purpose. The duty of prudent investing therefore reinforces the duty of loyalty in forbidding the trustee to invest for any object other than the highest return consistent with the preferred level of portfolio risk.[62]

In 1980, the then chief ERISA administrator, Ian D. Lanoff of the Department of Labor, rejected the suggestion that social investing was not subject to ERISA's rules of prudence and loyalty. He said that ERISA requires that the fiduciary's "overall investment strategy . . . be designed to protect the retirement income of the plan's participants," and that both the duty of loyalty and the prudent investor rule would be violated if a fiduciary were to make an "investment decision based on other objectives, such as to promote the job security of a class of current or future participants."[63] Social factors may be brought in only if it is costless to do so. Similarly, the Labor Department approved a 1979 Chrysler/UAW agreement endorsing some social investing of pension-fund assets on the understanding that the investments in question would be "economically competitive with other investment opportunities which may not contain similar socially beneficial features."[64] (As previously explained, the field for costless substitutions is largely limited to the economically futile forms of social investing.)

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[58]447 F. Supp. at 1256 (emphasis added).

[59]ERISA sec. 404(a)(1)(B), 29 U.S.C. sec. 1104(a)(1)(B).

[60]Restatement, supra note 33, at sec. 227.

[61]See Langbein & Posner, supra note 32, at 3-6.

[62]A similar rationale underlies the trustee's familiar duty to invest promptly, in order to make trust funds productive. See Restatement, supra note 33, at sec. 181, Comment c.

[63]Ian Lanoff, The Social Investment of Private Pension Plan Assets: May it Be Done Lawfully Under ERISA?, 31 Labor Law Journal 387, 389 (1980).

[64]Id. at 392.

The attorney general of Oregon issued a formal opinion in 1978 applying the state's statutory prudent-investor rule to the question whether investment managers for the state university endowment funds could "take political and moral considerations into account in making investment decisions." He ruled that "[i]t is inappropriate and irrelevant for the investment managers to consider any factors other than the probable safety of, and the probable income from, the investments required by the statute."[65]

The proponents of social investing have never reconciled the sacrifice of beneficiaries' financial advantage with the prudent-investor rule. Ravikoff and Curzan try to avoid the common-law rule by rewording it to suit their purpose. After quoting the *Restatement* version,[66] they purport to summarize it in a form which changes it radically, and which they thereafter treat as a statement of the law. The objects of the prudent-investor rule, they say, are "preservation of the trust corpus and attainment of an adequate return."[67] The term "adequate" is their own invention, and in thus implying a standard less than "optimal" or "maximum" it is wholly without authority. The authors later endorse a movement from "adequate" to "moderate or even no return,"[68] still in the name of prudence. It is a revealing commentary on the weakness of the legal case for social investing that its proponents are driven to such transparent manipulation of the legal rules that oppose them.

ERISA's No-Waiver Rule Applied to Social Investing. A general rule of trust-investment law, known as the authorization doctrine, permits the settlor to impose on the trust whatever investment policy he sees fit.[69] The settlor can waive otherwise applicable rules and authorize the trustee to engage in acts of self-dealing or imprudent investment. One of ERISA's innovations was the prohibition against "any provision . . . which purports to relieve a fiduciary from responsibility or liability."[70] Therefore, as Hutchinson and Cole observe, "the [pension] plan documents cannot authorize a policy of social investment that would otherwise be impermissible under the fiduciary standards of the Act."[71] This rule against exculpation clauses eliminated the authorization doctrine from pension trusts.

Consequently, a pension trust cannot be drafted to permit a social invest-

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[65]38 Op. Or. Atty. Gen. No. 7616, at 2 (May 2, 1978), litigated in Associated Students of the University of Oregon v. Hunt, No. 78-7503 (Lane County Cir. Ct., filed Nov. 22, 1978).

[66]Restatement, supra note 33, at sec. 227, quoted in Ravikoff & Curzan, supra note 44, at 520.

[67]Ravikoff & Curzan, supra note 44, at 520.

[68]Id. at 528.

[69]Restatement, supra note 33, at sec. 164(a).

[70]ERISA sec. 410(a), 29 U.S.C. sec. 1110(a). See also ERISA sec. 404(a)(1)(D), 29 U.S.C. sec. 1104(a)(1)(D).

[71]Hutchinson & Cole, supra note 50, at 1372, 1373-75.

ing strategy that would violate the duties of loyalty or prudent investment. This result is quite consistent with the economic analysis of pension savings (discussed in Part II, supra, under the subheading "Contributory or Not"). Because both employer-paid and employee-paid contributions are best understood as deferred wages, they derive from the employee's compensation packet. Since the employee is in this important sense the "settlor" of his own pension-trust account, there is good reason to prevent plan sponsors (whether union or employer) from using the authorization doctrine to impose social investing upon him.

Since, however, the employee rather than the plan sponsor is the settlor-equivalent person, the opposite question arises: Might a pension plan be lawful if it contained a social-investing option that the individual participant could elect or decline? For example, the plan might offer two funds, one that ignored social-investing causes and another that adhered to some political strategy such as excluding the securities of nonunion firms. The employee could elect between the two funds.

It might be possible to bring a social-investing option of this sort within the so-called ratification doctrine of the common law of trusts. Unless a beneficiary is deceived or acts under an incapacity, trust law allows him to ratify investment practices that would otherwise be in breach of the trust instrument or of the common law.[72] The idea is that if the beneficiary is entitled to receive and waste the trust fund, he is equally entitled to allow the fund to be wasted while still in the hands of the trustee. But it is just there that pension trusts part company from ordinary trusts, on account of the protective policy of pension law. The pension beneficiary is not allowed to reach pension assets on whatever terms please him. For example, we have seen that ERISA's mandatory spendthrift rule prevents the pension beneficiary from consuming his pension account before retirement.[73] Further, the Internal Revenue Code now conditions the pension tax concessions on the requirement that retirement benefits be made available in the form of an annuity,[74] in order to protect the retiree from improvident consumption that could exhaust his pension benefits during his lifetime.

Accordingly, it seems unlikely that a genuinely costly social investing scheme could pass muster even as a beneficiary-elected option. For the same reason we do not allow a current worker to spend his pension account on a sports car, we should not allow him to spend it on contributions to political or social campaigns (which is what he is doing when he accepts a below-market return in his pension savings). On the other hand, this ration-

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[72]Restatement, supra note 33, at sec. 216(1).

[73]Supra text at note 10 and note 10.

[74]I.R.C. sec. 401(a)(11) (as amended by the Retirement Equity Act of 1984).

ale seems not to extend to social investing schemes of the merely futile sort, such as in-state GNMAs. Even for these investments, however, the plan sponsor should be obliged to disclose to plan participants that the price of costlessness is futility; and the sponsor should be obliged to arrange for confidentiality respecting the portfolio election of each participant, in order to protect participants from union or other pressures.

This discussion of a social investing option presupposes a defined contribution plan, with individual accounts whose investment risk is borne by each plan participant. In a pure defined benefit plan, where investment risk is shifted to the employer as plan sponsor, there is less reason in law to prevent the employer from assuming the increased costs of a social-investing strategy that entails below-market yields. The employer, however, has good reason to resist such efforts to induce him to increase his pension costs and liabilities. For just that reason, most of the social-investing pressures have not been directed at single-employer defined benefit plans, but rather at union-dominated multi-employer plans, state-and-local plans, and multi-employer defined contribution plans such as the college teachers' TIAA-CREF.

Even within the realm of the defined benefit plan, the plan sponsor does not bear the whole of the investment risk. Under the federal insurance scheme enacted as Title IV of ERISA, a federal agency called the Pension Benefit Guaranty Corporation (PBGC) bears the ultimate responsibility for paying most of the pension benefits promised under a defined benefit plan, in the event that the plan should default.[75] PBGC thus has an interest in preventing plan sponsors from engaging in improvident investment practices that might require PBGC to have to honor the sponsor's defaulted promises. Furthermore, PBGC insurance does not protect plan participants wholly, because there are statutory ceilings on the amount of the benefits covered.[76] Since, therefore, the plan participant would remain at risk for the portion of a defaulted plan not insured by PBGC, the protective policies that indicate that the participant should not have the power to acquiesce in a social-investing option under a defined contribution plan pertain as well in an attenuated fashion to a defined benefit plan.

Corporate Social Responsibility. Proponents of social investing sometimes think they can find solace in the authorities that allow a corporation to engage in charitable giving or other "socially responsible" endeavors at the expense of its shareholders. Indeed, this analogy misled the distinguished

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[75]ERISA secs. 4001 et. seq., 29 U.S.C. sec. 1301 et. seq.
[76]ERISA sec. 4022(b)(3)(B), 29 U.S.C. sec. 1322(b)(3)(B).

trust writer, Austin Scott, who, shortly before his death endorsed social investing of trust funds.[77]

The legal analysis that has been applied in the corporation cases, is, in fact, directly contrary to that which would be needed to sustain social investing of trust funds. The rationale that has protected corporate directors from liability when shareholders have brought suit complaining of seeming corporate altruism is that the directors were in fact pursuing the longer-range self-interest of the firm and hence that their conduct has been wealth-maximizing.[78]

Constitutional Objections. There are serious doubts about the constitutionality of the two types of social-investing measures that crop up in state legislation directed at state and local pension funds. As regards the legislation directed against South Africa (or any other foreign power), I have previously mentioned the doctrine of constitutional preemption,[79] designed to preserve the federal monopoly of authority in foreign relations, which was expansively reaffirmed by the Supreme Court in the 1968 case of *Zschernig v. Miller*.[80]

There is also a long constitutional tradition inimical to protectionist state legislation. A main purpose of the commerce clause of the federal constitution was to create national markets. For example, the Supreme Court held in a famous case that New York could not by statute prevent price competition in New York from cheaper Vermont milk.[81] State legislation attempting to create perferences for in-state securities should be no more justifiable under

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[77]Scott writes:

> Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporation whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment and consumer responsibility . . . . Of course they may well believe that a corporation which has a proper sense of social obligation is more likely to be successful in the long run than those which are bent on obtaining the maximum amount of profits. [Scott is here reciting the social-bargain fallacy, refuted above in Part V of the present essay.] But even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society.

3 A. Scott, supra note 38, at sec. 227.17 (Supp. 1980). Scott makes no effort to reconcile his support for social investing with the trustee's duties of loyalty and prudence that he canvassed so extensively in the body of the treatise. 2 id. at sec. 170-170.25 (loyalty); 3 id. secs. 227-227.16 (prudent investing). He ignores the ERISA rules, discussed above, that contradict his position. Scott cites some of the literature on corporate social responsibility but does not disclose that the legal analysis that has been applied in the corporation cases is the opposite of the rule he is supporting for the law of trusts.

[78]See, e.g., Shlensky v. Wrigley, 95 Ill. App. 2d 173, 180-81, 237 N.E.2d 776, 780 (1968).

[79]Supra text at note 27.

[80]389 U.S. 429 (1968).

[81]Baldwin v. G.A.F. Seelig, 294 U.S. 511 (1935).

the commerce clause than legislation preferring in-state enterprises. The privileges-and-immunities clause of the constitution has also been interpreted to forbid protectionist legislation aimed at out-of-staters.[82]

VII. UNIVERSITY ENDOWMENTS

I have thus far considered the social-investing question only in context of the pension fund. The analysis changes when we move from pension trusts to charitable trusts (or to charitable corporations, which for present purposes are indistinguishable from charitable trusts).[83] This is an area of considerable consequence for university trustees; they are currently being pressured to apply social criteria to the investment of their endowment funds, and some boards of trustees have succumbed.

The distinguishing juridical feature of the charitable trust is the absence of conventional beneficiaries. A private trust (including the pension trust) must identify by name or by class the persons who are to receive the trust property, but a charitable trust is void if it is found to serve individual rather than community benefit.[84] The charitable trust occupies a legally privileged position: it is not subject to the rule against perpetuities; the attorney general or other public officer may enforce it; the cy pres doctrine protects it against ordinary rules of defeasance; and it enjoys a variety of tax and procedural advantages pursuant to statutes that follow the common law criteria for defining charitable trusts.[85] The law conditions the grant of these privileges on the requirement of indefiniteness of beneficiaries. A charitable trust will fail if "the persons who are to benefit are not of a sufficiently large or indefinite class so that the community is interested in the enforcement of the trust."[86]

In place of the definite beneficiaries of private trust law, the law of charitable trusts substitutes the standard of community benefit defined by a circumscribed set of charitable purposes: the relief of poverty; the advancement of religion; the advancement of education and of health (including research); and the promotion of governmental, municipal, and other purposes beneficial to the community.[87] At the border of each of these catego-

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[82]See, e.g., Hicklin v. Orbeck, 437 U.S. 518 (1978).

[83]See generally 4 A. Scott, supra note 38, at sec. 348.1.

[84]A recent Pennsylvania decision dealing with the claim of the Fraternal Order of Police to be a charitable organization concluded that the group "is essentially a labor organization existing solely for the benefit of its own membership," and those that "its benefits are not applied for the advantage of an indefinite number of persons as would be the case if the public were to benefit." Commonwealth v. Frantz Advertising, Inc., 23 Pa. Commw. Ct. 526, 533-34, 353 A.2d. 492, 496-97 (1976). For a good general background on such cases, see 4. A. Scott, supra note 38, at sec. 375.2.

[85]See Restatement, supra note 33, at secs. 365 (unlimited duration), 391 (public enforcement), 395 (cy pres).

[86]Id. at sec. 375.

[87]Id. at sec. 368.

ries there can be serious questions about whether particular schemes qualify, but the typical university charter declares purposes that fall unambiguously within the category of education and research (and often within that of health as well).

In analyzing social investing by private and pension trusts, we saw that the trustee's obligation to invest for the maximum financial well-being of the trust beneficiaries derives from the trustee's duties of loyalty and prudent investing; but since, by definition, the charitable trustee does not owe such duties to particular private beneficiaries, the question arises whether there are any legal impediments to social investing of university endowment funds. There are several:

Charter. University charters are often granted by special legislative act, both for state schools and private universities. A university may also be chartered under the general nonprofit corporation statute of the jurisdiction. In principle, an authorizing instrument under the common law of trusts would also suffice. Regardless of the form, a university's charter is usually restrictive; it dedicates the institution to educational and related purposes.

A variety of the causes espoused in the name of social investing are not within the purposes of such charters—for example, expressing disapproval of selected foreign governments, or supporting certain labor union organizing campaigns. For university trustees to spend university funds on such causes directly would be ultra vires and put the trustees in breach of their fidiciary duty to the institution.[88] Were the trustees to pursue the same end by engaging in social investing of the university's endowment funds, they would simply be attempting to do indirectly what they may not do directly.

Under conventional charitable trust law, the state attorney general has standing to sue to prevent such misuses of university endowment funds. Because he is a political officer, and there will often be more votes to gain from supporting than from opposing the groups that advocate social investing, his intervention might not always be a serious prospect. But the attorney general probably does not have a monopoly of standing in such cases; other persons who have a significant economic interest in the fate of the endowment—for example, professors and students—probably may sue.[89]

Noncharitable Purposes. If a particular charter is too restrictive to permit a particular scheme of social investing, the proponents of the scheme may reply that the institution ought to get its charter amended. When the charter originates in special state legislation, the legislature can authorize virtually any use of institutional funds (at least as regards the state law of charitable purposes, although not the federal tax consequences). When the charter is

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[88]See id. at sec. 379.

[89]In Coffee v. William Marsh Rice Univ., 403 S.W. 2d 340 (Tex. 1966), two opposing groups of alumni were held to have standing to intervene in a lawsuit in which the trustees of Rice University were seeking the application of the cy pres doctrine in order to eliminate racially restrictive provisions from the trust instrument that had created the school.

nonstatutory and subject to the common law of charitable trusts, valid charter amendments will be impossible for many social investing schemes. The law of charitable trusts denies private autonomy over the definition of what purposes qualify as charitable. The standard of community benefit does not vary with the tastes of universities or their founders, trustees, and donors.

Some of the schemes favored by proponents of social investing are incompatible with these legal standards. In England, a trust for the purpose of changing existing law is not charitable.[90] Although this rule generally has not been followed in American law, our law does attempt to distinguish between "social" purposes, which are permissible, and "political" purposes, which are not.[91] Trusts to promote socialist political and educational activity have been held not charitable;[92] a similar fate befell a bequest to create an educational and information center for the Republican women of Pennsylvania.[93] A Scottish case held that a trust to support resistance to strikebreaking and lockouts was political and hence void,[94] and a New Zealand case ruled similarly against a trust for the League of Nations.[95] University trustees faced with pressures to adapt their portfolios to the requirements of union organizing campaigns, or some group's foreign-policy views, must beware the force of such precedents. The price of yielding to social-investing demands may be litigation costs and potential liability for breach of fiduciary duty.

Costs. From a practical standpoint, university trustees are obliged to give full weight to the savings in administrative costs that result when the institution is spared the needless portfolio reviews and difficult investment decisions that are involved in social investing, especially in view of the absence of agreement on the social principles to be pursued.

Donors. Past donors—more likely their heirs or successors—may claim that since social investing constitutes a diversion from the educational purposes for which the funds were given, it breaches an implied or express condition and ought to trigger defeasance of the funds in favor of the donor. In Illinois, legislation in force since 1874 denies to universities the "power to divert any gift . . . from the specific purpose designed by the donor."[96] Donors would have a strong argument against applying the cy pres doctrine in order to prevent defeasance, since cy pres applies only when it "becomes impossible or impracticable or illegal to carry out the original charitable

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[90]National Anti-Vivisection Soc'y. v. Inland Revenue Commrs., [1948] A.C. 31.
[91]4 A. Scott, supra note 38, at sec. 374.6.
[92]See id.
[93]Deichelmann Estate, 21 Pa. D. & C.2d 65 (1959).
[94]Trustees for the Roll of Voluntary Workers v. Commrs. of Inland Revenue, [1942] Sess. Cas. 47.
[95]In re Wilkinson, [1941] N.Z.L.R. 1065.
[96]Ill Rev. Stat. 1971, ch. 144, sec. 1.

purpose."[97] Thus, trustees who yield to pressures to divert endowment funds from education to other causes are exposing their endowments to the restitutionary claims of donors and heirs.

VIII. CONCLUSION

In emphasizing the legal risks that pension trustees and university and other charitable trustees incur in pursuing social investing, I do not suggest that the law requires social grievances to go without remedy. The law of trusts has been constructed on the quite intelligent premise that the grand social issues of the day should be resolved in those institutions whose procedures and powers are appropriate to them. The political and legislative process of the modern democratic state is well adapted to dealing with pressures for social change. Pension trusts have been designed to provide retirement security, and charitable trusts have been designed to serve specialized purposes—in education, healing, the arts, research, and so forth. A board of trustees is not well suited to be a forum for the resolution of complex social issues largely unrelated to its work. There is every reason to think that trustees will best serve the cause of social change by remitting the advocates of social causes to the political arena, where their proposals can be fairly tested and defined, and if found meritorious, effectively implemented.

[97]Restatement, supra note 33, at sec. 399.

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May 9, 1995

VIA HAND DELIVERY

E. Olena Berg, Assistant Secretary
Pension and Welfare Benefits Administration
United States Department of Labor
Room S-2524
200 Constitution Avenue, N.W.
Washington, DC 20001

Dear Ms. Berg:

In accordance with your inquiry, it is my opinion that the ERISA legal standards contained in Interpretive Bulletin No. 94-1, as they would apply to pension plan investment in economically targeted investments ("ETI's"), are exactly the same as the ERISA legal standards which have been employed by the U.S. Labor Department since the late 1970s when I served as ERISA Administrator at the Department.

This opinion is based upon my government service as Administrator during the final three years of the Carter administration and the first full year of the first Reagan administration. It is further based upon my law practice in the private sector where I have specialized since 1981 in advising fiduciaries of corporate, multiemployer and public employee pension funds regarding compliance with ERISA, state and municipal legislation, and trust law. In my practice, I have been required to pay close attention to the rulings and regulations issued by the ERISA program of the Department when advising fiduciaries regarding investment decision-making, including investment in ETI's.

Sincerely,

Ian D. Lanoff

/jpt

LENS INC.

ROBERT A. G. MONKS
NELL MINOW
JOHN P. M. HIGGINS
ROBERT B. HOLMES

May 8, 1995

via facsimile and u.s. mail

Honorable Olena Berg,
Assistant Secretary of Labor
U.S. Department of Labor, PWBA
200 Constitution Avenue, NW - S2524
Washington, D.C. 20210

Dear Olena,

You have asked me to write confirming many conversations that we have had with respect to the Department of Labor's ("DOL") policies relating to what has variously been referred to as "Social Investing" or "Economically Targeted Investments" ("ETI"). In my opinion, Interpretive Bulletin 94-1 sets forth a policy that is consistent with the policies announced by DOL during the years that I had principal responsibility for the ERISA program.

In the PWBA Fact Sheet accompanying announcement of IB 94-1, the Department concludes:

"The department clarified in the bulletin that investments in ETIs are governed by the same ERISA standards as are other plan investments.

Plans may invest in ETIs if: the ETI investments are expected to provide risk-adjusted rates of return commensurate with competing investments of similar characteristics; and the ETI investment is otherwise appropriate for the plan in terms of such factors as diversification and the investment policy of the plan." 6/22/94.

I described the appropriate investment criteria in comparable language on December 7, 1984 in speaking to the Florida Labor/ Management Council at West Palm Beach, Florida:

LENS INC.

ROBERT A. G. MONKS
NELL MINOW
JOHN P. M. HIGGINS
ROBERT B. HOLMES

May 8, 1995

"Congress, speaking through ERISA, stated that investment objectives that provide the greatest return to the plan consistent with acceptable risk must be paramount. However, that DOES NOT MEAN that plans must ignore deeply felt social views when faced with investment of equal investment merit." (emphasis added).

I write because I share your concern that the tens of millions of Americans who are benefiting from the vast success of ERISA have confidence in its consistent administration for their exclusive benefit. In my view, DOL's policies requiring investments be made for the "sole" purpose of benefiting plan participants are unchanging and inveterate.

Respectfully Yours,

Robert A.G. Monks

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U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of:

JUN 3 1980

Mr. John Thomas Kenney
Manager, Benefit Programs
Chrysler Corporation
P. O. Box 1919
Detroit, Michigan 48288

Dear Sir:

I am writing in reply to your letter of April 14, 1980, in which you seek an Advisory Opinion concerning the lawfulness under the Employee Retirement Income Security Act of 1974 (ERISA) of a certain understanding denominated the "Letter Agreement" or "Agreement" between the Chrysler Corporation (Chrysler) and the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW). That agreement, furnished with your request, was the only document submitted for the Department's consideration. We have met with representatives of Chrysler and the UAW and, among other things, pointed out that the intended construction of the agreement is not in all respects clear. You have, however, made certain representations regarding the manner in which the agreement embodied in the memorandum of understanding is expected to work in practice.

Based on these representations and on our reading of the memorandum submitted for our consideration, we have reached the following conclusions regarding the agreement as it is to be applied. The pension plan assets are now and will continue to be held in trust and exclusively managed by trustees. In order to assist the trustees by providing an expanded range of information concerning investment opportunities, Chrysler and the UAW have agreed to establish an Investment Advisory Committee consisting of three members appointed by Chrysler and three members appointed by the UAW. The primary functions

2

of this Committee will be (1) to obtain information concerning and select and recommend to the trustees of the Pension Plan, geographical areas of communities in which residential mortgage financing could be provided by the Plan; and (2) on an annual basis, to recommend to the trustees opportunities for investments in debt obligations of nursing homes, nursery schools, federally qualified health maintenance organizations, hospitals or similar nonprofit institutions in communities where there are large concentrations of UAW members. The residential mortgage investment opportunities which the Committee will seek to identify will be primarily mortgages 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 community involved. It is intended that such mortgage financing recommendations will be for financing at rates and upon terms prevailing in the communities selected and will be available to the general public, including UAW members, but shall not be limited only to UAW members. For each year this agreement is in effect, the Committee is expected to make sufficient recommendations for such investments to permit the trustees to consider investment of 10 percent of the amount of Chrysler contributions available for investment after deductin the portion of the benefits payable for such year which is in excess of investment income (excluding realized and unrealized capital gains).

We understand that the Committee will act by majority vote, and in the event of a tie, the deciding vote will be cast by an impartial chairman chosen pursuant to the collective bargaining agreement.

It also appears that for each year this agreement is in effect, the Union may draw up a list of not more than five companies which conduct business with South Africa but which have not supported the elimination of racial discrimination there in specified ways, and recommend that the trustees make no new investment in such companies. You indicate that any such recommendations will not relate to any portion of the Pension Fund invested in common or collective trust funds or pooled investment funds, or to any insurance contract constituting part of the Pension Fund.

The trustees, in the exercise of their discretion, may reject any or all recommendations of the Committee and the Union or invest more funds in projects identified by the Committee than recommended. Our reading of the memorandum of understanding between Chrysler and the Union in light of your subsequent representations indicates that the trustees will retain full investment discretion regarding the assets of the Pension Fund, and that it is fully understood that the trustees must exercise this discretion in accordance with the requirements of the Act. Accordingly, the trustees will possess full authority to implem or not to implement any recommendation made to them by either the Committee or the Union. In this regard, you represent that neither Chrysler nor the Union will attempt publicly or private to influence the trustees regarding specific recommendations of the Committee or the Union.

It appears to us that the purpose of the structure established by this agreement is to call to the attention of the Fund trust areas of investment opportunity which, although perhaps not generally explored by certain traditional investment managers, may nonetheless be prudent and potentially profitable. As you are aware, Title I, Subtitle B, Part 4 of the Act contains a number of provisions regarding fiduciary responsibility with re to employee benefit plans. Section 403 of the Act provides generally that the trustee of a plan shall have exclusive authorit and discretion to manage and control the assets of the plan. Pursuant to section 404 of the Act, a trustee or other fiduciar must discharge his duties with respect to a plan solely in the interests of plan participants and beneficiaries, and in a prud manner in accordance with section 404(a)(1)(B) of the Act and regulation 29 CFR §2550.404a-1. Further, a trustee or other fiduciary must not cause the plan to engage in any of the prohibited transactions in sections 406(a) or 407 of the Act. The trustee or fiduciary himself must not engage in any of the prohibited transactions listed in section 406(b) of the Act, which describes certain transactions involving self-dealing and conflicts of interest.

4

If the memorandum of understanding submitted for our consideration is construed and put into practice in the manner outlined above, it is the opinion of the Department that such effectuation of the agreement between Chrysler and the UAW would not of itself involve violations of the provisions of Title I, Subtitle B, Part 4 of the Act and the regulations promulgated pursuant thereto. However, the Department, by this letter, expresses no opinion regarding the lawfulness of any specific transaction which may be undertaken by the Union, the Committee or the trustees in connection with this agreement or otherwise.

Sincerely,

Ian D. Lanoff

Ian D. Lanoff
Administrator
Pension and Welfare Benefit Programs
Labor-Management Services Administration

U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of:

JAN 16 1981

Mr. George Cox
Cox, Castle & Nicholson
Two Century Plaza
Los Angeles, California 90067

Dear Mr. Cox:

I am writing to advise you of the Department's conclusions and concerns in connection with the Construction Industry Real Estate Development Financing Foundation of Southern California ("the Foundation"). On October 22, 1980, Alan Lebowitz and Sherwin Kaplan of my staff met with you and three of your associates to discuss the Foundation. Prior to that meeting, Department staff had met with Messrs. Albert Brundage and John F. Hebert of Union Mortgage Bankers to discuss an earlier proposal designed to pool assets of various employee benefit plans for the purpose of financing real estate construction projects. We had also received from Mr. Brundage a copy of a draft document establishing the Foundation as well as a draft copy of a proposed Transaction Trust Agreement.

As you are aware, our interest in the creation and structure of the Foundation originally arose from published articles which indicated that a consortium of southern California Taft-Hartley employee benefit plans, all affiliated with the construction trades, were seeking to join together in a "super trust" which would invest the plans' assets in union-only construction projects in the southern California region. Upon becoming aware of this proposal, members of my staff immediately advised Mr. Brundage and others that in the Department's view ERISA mandates that employee benefit plan fiduciaries must, in formulating and executing investment policies, consider only the interest of participants and beneficiaries of their plan and that such policies must, in the first instance, be based solely on economic considerations. Specifically, our concern, as expressed to both Mr. Brundage and to you, was that if fiduciaries of employee benefit plans were to determine to invest only in, or to consider only, union construction projects in southern California, they would be artificially limiting their potential investment opportunities for non-economic reasons.

As we understand the current proposal, however, the object of the arrangements now under consideration is to broaden, rather than to restrict, the range of investment opportunities available for plans. Based on the written materials we have received and the information provided by you at the October 22 meeting in Los Angeles, we understand that the Foundation will serve as a forum for presentation to fiduciaries of member plans of proposed construction projects for possible investment. Plans which are members of the Foundation are not obligated to invest in any project presented at a meeting of the Foundation. Rather, fiduciaries of each member plan, acting solely on behalf of their respective plans, consider each proposed project as a possible investment, and compare it with other available investment opportunities. They then decide on behalf of their plan whether to invest in that project. Each plan arrives at its decision independently of all other plans. Plan fiduciaries will not make advance commitments of funds for investment in any project presented at a Foundation meeting. As we understand it, fiduciaries of each individual plan will continue to consider a broad range of relevant investment opportunities and, based on such consideration, will make the investment determinations believed to be in the best interest of their plan's participants and beneficiaries. In so doing, they will consider proposals presented through the Foundation along with other possible investments. Ultimately, each plan's fiduciaries retain full discretion with regard to their plan's investments and are responsible for the investment decisions made. Under the circumstances, it appears to us that membership in the Foundation will not inappropriately limit the investment alternatives available to plan fiduciaries, and that the use of the Foundation concept, as described above, would not in itself violate any of ERISA's fiduciary standards.

We have not had the opportunity to consider the instruments by which plan assets committed by Foundation member-plans to loan projects are collected and disbursed. You have indicated to our staff your own belief that, where a given project is selected by plan fiduciaries with the understanding that it is to be constructed with union labor, the financing would be disbursed only if that condition is met. Without speculating unduly on the variety of circumstances in which ERISA violations could occur in relation to such an objective, we believe that all involved with the Foundation should be alert to these dangers. Not only the fiduciaries who make an initial decision to invest

plan assets in a particular project, but also all those fiduciaries subsequently involved, are subject to the requirements of section 404 to act prudently and solely in the interest of plan participants. Thus, for example, in determining whether and for what reasons to enforce or decline to enforce any given right of a lender where the loan is to be of plan assets, a fiduciary could not take a course of action which would not be the most advantageous economically to the lender plans. In deciding to enforce or decline to enforce a given right, a fiduciary may act on the basis of non-economic considerations, but only if such action does not in any way violate the fiduciary's duty set forth immediately above; that is, a fiduciary might choose on the basis of non-economic considerations between two alternatives which in his judgement were economically equally advantageous.

We are aware of your intention to structure the Foundation in such a way that neither the mortgage bankers who may be making presentations at Foundation meetings, nor the Foundation itself, would be fiduciaries with respect to any member employee benefit plan. Because of the fact that ERISA section 3(21) provides that the test to be employed to determine whether a fiduciary relationship exists in a given situation is generally functional rather than structural (although certain positions, by virtue of the power they confer, may make one a fiduciary for structural reasons), we cannot, at this point, comment on whether such a relationship will have been established in this situation. In this regard, the Department's Los Angeles Area Office is currently conducting two investigations of employee benefit plans which may be or intend to become members of the Foundation. Upon the completion of these investigations, it may be possible for the Department to determine whether the Foundation or the mortgage bankers, in practice, maintain a fiduciary relationship to specific employee benefit plans.

Two other aspects of the Foundation proposal as we currently understand it raise ERISA questions which we believe would be of concern to the fiduciaries of plans participating in the Foundation and which you may, therefore, wish the bring to their attention. These are: the provisions which appear to restrict severely the ability of an employee benefit plan to dispose of its interest in a "Transaction Trust" during the entire life of that trust; and the provision which provides that an individual employee benefit plan might be required to invest more than its fiduciaries had previously agreed to in a specific Transaction Trust.

The facts concerning these matters as well as others relating to the proposed operation of the Foundation are not sufficiently well developed for an expression of the Department's opinion at this time. Since the proposed Foundation documents presented to us appear to have satisfied our original concerns, we do not intend to take any further action at this time. You are cautioned, however, that neither the approval previously expressed of the Foundation concept as we understand it nor our intention to take no action at this time constitutes approval of how the Foundation would, in fact, operate.

Once the Foundation has been in operation for a period of time, we may, pursuant to section 504 of ERISA, review its activities and those of the fiduciaries of participating plans to determine whether the Foundation and its member employee benefit plans are functioning in compliance with the fiduciary provisions of ERISA. Of course it remains the responsibility of each plan fiduciary to determine that the plan to which each owes a fiduciary responsibility is, at all times, managed in a manner consistent with the obligations imposed by ERISA. In this regard, we view your proposal to establish and operate the Foundation in a manner which does not appear to limit the investment opportunity of any plan participating in it as a hopeful and constructive indication of an intention on the part of all concerned to operate these plans in a manner consistent with ERISA.

Sincerely,

Ian D. Lanoff
Administrator
Pension and Welfare
Benefit Programs

U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of:

JAN 16 1981

Theodore R. Groom
Lawrence J. Haas
Groom and Nordberg
1775 Pennsylvania Avenue, N. W.
Washington, D. C. 20006

Gentlemen:

This is in response to your letter and supporting memorandum, both dated December 30, 1980, requesting and advisory opinion from the Department of Labor with regard to whether the operation of two proposed Prudential Life Insurance Company of America (Prudential) pooled separate accounts, one of which is expected to consist primarily of mortgage loans on real properties which are developed or improved with only union labor ("union preferred account") and a second which would not consider whether the proposed development or improvement would employ union labor ("union neutral account"), would violate the fiduciary responsibility provisions of §404 of the Employee Retirement Income Security Act of 1974 (ERISA). As you know, ERISA Procedure 76-1 (41 FR 36281, August 27, 1976) provides the general procedures of the Department in issuing an advisory opinion with regard to ERISA. Section 5 of that Procedure retains for the Department the discretion not to issue an advisory opinion where, among other things, the issue presented is inherently factual in nature. Obviously, any determination as to the actual operation of these two particular investment arrangements can not be made in advance of their implementation. We have, however, decided to respond to your request to the extent possible at this time.

In your memorandum, you describe the three stage process whereby Prudential currently selects its mortgage investments and how this process would be applied to the two proposed new accounts. The first stage now consists of a review of each loan application by one of the more than 50 Prudential field offices located throughout the country during which Prudential's previously established financial standards and procedures for evaluating mortgage loan investments are applied. According to your memorandum, this stage will remain unchanged; there would be no consideration whatsoever of

whether the project for which the loan has been requested will be developed or improved with union or non-union labor. You specifically state that Prudential's field offices will be "instructed not to favor, or to discriminate against, proposed mortgage loans on the basis of whether improvements on the property will or will not be constructed with union labor".

Once a proposed mortgage investment is approved and recommended by a field office, it is sent to the corporate office of the Real Estate Investment Department for corporate review. Initial review at this second stage would be performed by a real estate analyst who, like the field office, would consider the proposal solely on the basis of its economic merits, without regard to, for example, whether the property would be constructed or improved with union or non-union labor. Upon approval by the analyst, the proposed loan would be forwarded to the corporate officer in the Real Estate Investment Department responsible for mortgage loan activity. At this point in the second stage of the approval process, the question whether the project contemplates using union labor would be considered for the first time. According to your memorandum, such consideration would only be for the purpose of determining whether the loan funds would come from Prudential's general account, its union preferred account or its union neutral account.

At the same time, consideration would also be given to the amount of cash available in each account for investment purposes and the diversification requirement of each account. With regard to diversification, your memorandum expressly states that emphasis will be placed on maintaining portfolios which are not overly concentrated in mortgages secured by any one type of property (e.g., office buildings, warehouses or shopping centers, etc.) or mortgages secured by property concentrated in any specific geographic area. You indicate that Prudential will not make a commitment to any participating employee benefit plan to direct its investments to a region containing union members participating in that plan.

Finally, you state that, even though Prudential will make every effort to place only union built projects in the union preferred account, in the event a specific project placed in that account uses non-union labor, the investment would nonetheless remain in the union preferred separate account. Thus,

no absolute guarantees would or could be given by Prudential that the union preferred account would invest exclusively in union only projects, but, rather, Prudential would merely promise to use every effort to see that such a result were obtained.

Once the corporate office of the Real Estate Investment Department has approved a proposed loan application, unless the loan is for less than a specified amount, a third stage process of review and final approval would be undertaken by Prudential's Finance Committee.

In our view, this approach, as outlined in your memorandum, would not be inconsistent with the requirements of §404 of ERISA merely because investments allocated to one of the new accounts are expected to consist primarily of mortgage loans on properties that are developed or improved only with union labor. If you have any additional questions with regard to our views on this matter, please do not hesitate to contact either me or members of my staff.

Sincerely,

Ian D. Lanoff
Administrator
Pension and Welfare
Benefit Programs

MAY 19 1981

Trustees of the Twin City
Carpenters and Joiners
Pension Fund
2850 Metro Drive
Suite 404
Bloomington, Minnesota 55420

Gentlemen:

The Department of Labor has responsibility for administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Title I establishes standards governing the operation of employee benefit plans such as yours and two other plans that are receiving [redacted] assistance.

The Minneapolis Area Office of the Labor-Management Services Administration has recently concluded an investigation regarding the participation of your plan and the two other plans in a program sponsored by the Minneapolis/[redacted] Family Housing Fund designed to provide funds [redacted] equity participation loans for the construction and rehabilitation of low and moderate income housing in the cities of Minneapolis and St. Paul.

Based on the facts gathered during this investigation, and subject to the possibility that additional information may lead us to revise our views, it appears that, as trustees, you will be breaching your fiduciary obligations to the plan if you commit plan assets to the project as it is presently conceived. The purpose of this letter is to advise you of our findings and to give you an opportunity to reconsider your position prior to committing funds to the project.

As we understand the facts, many of which were provided by you and officials of the Family Housing Fund during the course of our investigation, your plan, two other employee benefit plans subject to coverage of ERISA, one municipal

employee benefit plan not subject to the coverage of ERISA, the McKnight Foundation and the cities of Minneapolis/ St. Paul (using funds provided by an urban development action grant (UDAG)) propose to make available, through the Family Housing Fund, 30% of the funds necessary to construct 1600-1800 new, and substantially rehabilitate 1200-1400 existing, units of residential property in the Minneapolis/St. Paul area. The remaining 70% of the funds will come from the sale of municipal bonds by the cities of Minneapolis/St. Paul. Funds provided by the plans and the McKnight Foundation, which will be secured by a Family Housing Fund Note, will not be structured as would a conventional mortgage, but, rather, would be in the form of an equity participation loan whereby no return on either principal or interest would be realized until houses are sold by the original buyers.

It is contemplated that the main source of funds for the return on investment to be realized by the plans will be the appreciation of the property between the time it is constructed and the time it is sold by its first buyer. As a method of guaranteeing a return to the plans, UDAG has agreed to receive no return on either its principal investment or interest until all principal has been repaid to the plans as well as a "profit" equal to an annual interest rate not to exceed 13%. To further insure that the plans receive a return on investment equal to 13% a year, the McKnight Foundation has agreed to accept a lower interest rate, estimated to be in the range of 3% to 7%, depending on the appreciation of each piece of property.

Purchasers of homes financed by these equity participation loans will make lower mortgage payments than would be the case if the entire mortgage were conventionally financed. This is true because principal and interest payments will, in effect, be based on only 70% of the total mortgage amount; that money accumulated through the sale of municipal bonds. Thus, one of the main goals of the program is to provide housing at a reduced rate to those who otherwise might not be able to afford it.

The ultimate success of the program is based on many assumptions and variables. For example, one individual connected with the Department of Housing and Urban Development had stated that for the program to operate as designed without additional funding, the proposed revenue bonds would have to be issued

at an interest rate of no more than 10 3/4%. Also, the program contemplates an average appreciation rate of 7% on each of the units and has assumed a prepayment rate of 140% of the actual rate of prepayment for all FHA insured mortgages from 1957-1977. It has been stated by officials connected with the Family Housing Fund that these assumptions are conservative in light of recent experience in the Minneapolis/St. Paul area. The past experience relied on, however, is experience based on statistics using the Metropolitan area as a whole and does not make special allowances for the fact that the mortgages here, in effect, will be subsidized, thus potentially adversely affecting the prepayment rate, and that large percentages of the houses built will be constructed in depressed areas, thus potentially lowering the rate of appreciation or, possibly, resulting in actual depreciation.

We are aware of several projections [redacted] Housing Fund which estimate that this [redacted] will be negative from 6.27% (assuming [redacted] of zero) to 13%. The fact that any returns [redacted] possible in the worst case scenarios is due solely to the "guarantee" provided by the UDAG funds. As we understand the program, however, the Department of [redacted] Development has reserved the right to withdraw [redacted] at any time if it determines that insufficient amounts of the newly constructed housing is being provided for low income families. No projections have been prepared [redacted] an overall depreciation of the property and, even in the best of situations, the plan's return is capped at 11%.

As the program is structured, the Family Housing Funds Notes which the plans will hold, will occupy a subordinate position to the Program Notes which will secure the funds obtained through the sale of municipal bonds. Therefore, in our view, as well as in the view of an investment advisor to one of the plans, the plans' security position will be roughly equivalent to that of the holder of a second mortgage.

Based on these facts, and others disclosed in our investigation, we have concluded that plan fiduciaries based their decision to tentatively participate in this program, in substantial part, on factors other than a strictly economic analysis

of what investment opportunities would be in the best interest of plan participants and beneficiaries. While the Department is not opposed to employee benefit plans investing in housing mortgages or any other type of secure investment, it is our view that the considerations which lead to the approval of any investment must, in the first instance, be based solely on economic factors relating to that investment, such as possibility of gain and risk of loss. In this regard, it should be noted that conventional first mortgages not only currently yield returns in excess of 13% a year, but also result in payments on a monthly basis which are not dependent on any future sale of the property. Based on the increased risk, marketplace returns for second mortgages are considerably higher.

In our view, were you to proceed to participate in the program as described above, you would be in violation of ERISA, [redacted] and (B) [redacted]

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 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;

We have provided the foregoing statements of our views to help you evaluate your obligations as fiduciaries within the meaning of ERISA. Should you wish to discuss this matter further, representatives of the Department will be happy to meet with you at any time to more fully explain

our views and to be appraised of any additional information you might care to provide. The person to contact within the Department with regard to this matter is Virginia Bartlett, who may be reached at (202) 523-8645.

Sincerely,

Ian D. Lanoff
Administrator
Pension and Welfare
Benefit Programs

cc: Lanoff Info Enforcement Chron Minneapolis AO
Chicago RO Gewin Bartlett SOL (Gallagher)

LMSA:PWBP:[redacted]
5-15-81 [redacted]

U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the attention of: Ivan Strasfeld
(202) 523-8971

MAR 15 1982

Mr. Ralph P. Katz
Delson & Gordon
230 Park Avenue
New York, N.Y. 10169

Re: Annuity Fund of the Electrical Industry
of Long Island
Identification Number: F-1998A

Dear Mr. Katz:

This is in reply to your request of June 5, 1981, for an advisory opinion on behalf of the Annuity Fund of the Electrical Industry of Long Island (the Fund) concerning the Fund's proposed investment in guaranteed investment contracts of insurance companies who would obligate themselves to invest in construction mortgages in the geographic area of the Fund. Specifically, you requested an opinion that the purchase of these contracts would not contravene the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

You represented in your letter of June 5 and in subsequent correspondence with the Department that the Fund is a defined contribution plan in which all employer contributions are credited to individual accounts in the names of participants for whom money has been paid. The trustees of the Fund intend to invest in guaranteed investment contracts (GICs) of insurance companies who would promise to invest in construction mortgages for commercial, industrial and residential land and structures in Nassau and/or Suffolk Counties, New York, engaging only contractors who are parties to collective bargaining agreements with unions affiliated with the Building and Construction Trades Council of Nassau and Suffolk Counties, New York, A.F.L. - C.I.O. The trustees reason that these contracts will stimulate construction activity and thereby increase contributions to the Fund. We understand from your correspondence that the trustees will seek bids from insurance companies on contracts with and without this provision and that the trustees would only enter into contracts offering the highest return. In computing total return, the trustees will take into consideration income earned on employer contributions made possible or stimulated by the insurance company's obligation to invest in contruction projects.

Sections 5.01 and 5.02 of ERISA Procedure 76-1 (41 FR 36281, August 27, 1976) provide that the Department of Labor (the Department) ordinarily will not issue advisory opinions on the

application of section 404(a) to particular fiduciary conduct or on questions which are of an inherently factual nature. For these reasons and because the Department has expressed general views which are relevant to the type of transaction involved in this case, we are responding to your request in the form of an information letter, which is described by section 3.01 of ERISA Procedure 76-1.

In performing investment duties for a plan, fiduciaries are subject to the general fiduciary responsibility standards contained in section 404(a)(1) of ERISA. Section 404(a)(1) requiries, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. As you know, the Department, on a number of occasions, has expressed its views as to the meaning of these requirements in the context of investment decision-making.

We have stated that, to act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan. Because guaranteed investment contracts are investments which would be selected, if at all, in preference to alternative investments, a contract would not be prudent if it provided a plan with less return, in comparison to risk, than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.

We have construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in guaranteed investment contracts, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment may not be influenced by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan. In this regard, we note your representation that it is for the purpose of maximizing trust fund income that the trustees seek to obtain the investment commitment from the insurance companies in addition to a commitment for the payment of interest.

The portion of your proposal which computes total return by taking into account income estimated from the investment of additional contributions generated by a particular investment contract appears speculative in nature and may be inconsistent with the fiduciaries' duty to judge a particular investment solely on the basis of its economic value to the fund. Although you make representations regarding the Fund's ability to quantify the value to participants of the additional income generated from the investment commitment, it does not appear from your numerous submissions that the Fund could accurately compute the direct impact of the commitment on each participant's individual account. Of course, it remains the responsibility of each Fund fiduciary to analyze investment alternatives in a manner consistent with the requirements of section 404(a)(1) of ERISA.

With respect to your inquiry concerning the prohibited transaction provisions of ERISA, section 406(a)(1)(B) provides that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he or she knows or should know that the transaction constitues a direct or indirect lending of money or other extension of credit between the plan and a party in interest. Section 406(a)(1)(D) similarly prohibits a fiduciary from causing a plan to engage in a transaction, if he or she knows or should know that the transaction constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. The term "party in interest" is defined by ERISA section 3(14) to include a fiduciary and an employer any of whose employees are covered by the plan. Further, section 406(b)(1) of ERISA prohibits a fiduciary from dealing with the assets of a plan in his or her own interest or for his or her own account. Section 406(b)(2) prohibits a fiduciary from acting in any transaction involving the plan on behalf of a party, or representing party, whose interests are adverse to the interests of the plan.

ERISA Interpretative Bulletin 75-2, 29 CFR §2509.75-2, expresses the general proposition that if an insurance company issues a contract or policy of insurance to a plan and places the consideration for such contract or policy in its general asset account, the assets of such account shall not be considered to be plan assets. Therefore, a subsequent transaction involving the general asset account between a party in interest and the insurance company will not, solely because the plan has been issued such a contract or policy of insurance, be a prohibited transaction. However, this does not mean that an investment of plan assets in an insurance contract may not be a prohibited

transaction. Thus, the purchase by a plan of an insurance policy pursuant to an arrangement under which it is expected that the insurance company will make a loan to a party in interest is a prohibited transaction.

We hope this information has been helpful.

Sincerely,

Alan D. Lebowitz
Assistant Administrator for
Fiduciary Standards
Pension and Welfare Benefit Programs

U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of

JUL - 1 1982

Mr. William J. Chadwick
Paul, Hastings, Janofsky & Walker
22nd Floor, 555 S. Flower Street
Los Angeles, CA 90071

Re: Pacific Mutual Life Insurance Company (the Insurer)
Exemption Application No. D-3272

Dear Mr. Chadwick:

The Department of Labor (the Department) has reviewed the above referenced application for exemption from the prohibitions of section 406 of the Employee Retirement Income Security Act of 1974 (the Act) and from the sanctions resulting from the application of section 4975 of the Internal Revenue Code of 1954 (the Code). Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) effective December 31, 1978, the authority of the Secretary of the Treasury to issue rulings and exemptions under section 4975 of the Code, with certain exceptions not here relevant has been transferred to the Secretary of Labor.

The transaction involves the proposed investment by separate accounts (the Separate Accounts) managed by the Insurer in real estate mortgage loans to owners of real property when (1) pension plans, particularly multiemployer plans, invest in the Separate Accounts and (2) employers of plan participants or affiliates of such employers (collectively, the Employers) may construct improvements on such real property.

The application states that (a) the Separate Accounts will not invest in mortgage loans to the Employers or to other parties in interest with respect to the plans (the Plans, which invest in the Separate Accounts; (b) the mortgage loans will be secured by income-producing properties located in the geographical areas covered by the Plans; (c) the mortgage loans will be made to borrowers who intend to construct improvements using union labor if the Insurer previously determines that investing in such loans will be consistent with the fiduciary requirements of section 404 of the Act, in that all mortgage loans will be subject to the same standards without regard to whether construction will be by union or non-union labor; (d) as a result of the emphasis on union-built projects and the geographical

concentration of the investments, the mortgage loans may benefit the Employers who may construct the improvements; (e) no arrangements to have specific Employers construct the improvements are contemplated; (f) no Plans or Employers will have a controlling influence over the Separate Accounts' decisions; (g) the Insurer, as investment fiduciary, will exercise sole discretion over all assets in the Separate Accounts; (h) no more than 15% of any Plan's assets may be invested in a Separate Account; and (i) no multiemployer plan may have a greater than 25% interest in a Separate Account.

As you know, 29 CFR §2509.75-2 provides that generally a transaction between a party in interest with respect to a plan and a corporation or partnership in which such plan has invested would not constitute a prohibited transaction if there is no prior understanding between the plan and the corporation or partnership regarding the subsequent transaction between the corporation or partnership and the party in interest. However, such transaction would be prohibited if it is of the type described in section 406 of the Act and either the plan alone or the party in interest and certain related parties in interest, with the plan's aid, may require the corporation or partnership to engage in the transaction. The related parties in interest are those described in section 3(14)(E) through (I) of the Act.

Thus, for example, as stated in the preamble to Part B of Prohibited Transaction Exemption 76-1 (PTE 76-1, 41 FR 12740, 12743, March 26, 1976), the Department believes that a loan by a multiple employer plan to an owner of real property who is not a party in interest with respect to such plan would not constitute a prohibited transaction even if the loan is for the purpose of enabling such property owner to construct improvements on such real property and the property owner contracts with an employer participating in the plan to construct the improvements. However, the Department also states (same paragraph) that such a loan may give rise to a prohibited transaction if, for example, the loan is made in the context of an arrangement for a specific participating employer to furnish a portion of the construction, and such employer has a controlling influence over the plan's decision to make the loan.

It is the Department's view that the proposed investments described in your application are similar to those described in the preamble to Part B of PTE 76-1 and are subject to the

provisions of section 2509.75-2 of the regulations. In this regard, determinations must be made as to whether a mortgage loan is made in the context of an arrangement for a specific Employer to furnish a portion of the construction; and whether the Separate Account may be required to invest in a particular mortgage by either a Plan alone or an Employer and parties in interest within the meaning of section 3(14)(E) through (I) of the Act, with the aid of a Plan. Because these questions are inherently factual in nature, the Department generally will not issue opinions on whether investments of this type meet the conditions of section 2509.75-2 and hence are not prohibited transactions (see section 5.01 of our Advisory Opinion Procedure, ERISA Proc. 76-1, 41 FR 36281, August 27, 1976).

The Insurer or other appropriate named fiduciaries must determine in light of all the relevant facts and circumstances whether the proposed investments by the Separate Accounts satisfy the conditions of section 2509.75-2 of the regulations. If these conditions are satisfied, no administrative exemption would be necessary for these investments. Accordingly, your exemption application will be closed by the Department without further action.

With respect to the union-labor and geographic considerations regarding the loans mentioned above, we wish to point out that section 404(a)(1) of the Act requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries, when making investment decisions on behalf of a plan.

In order to act prudently in making investment decisions, the Insurer must consider, among other factors, the availability, riskiness, and potential return of alternative investments for the Separate Accounts. However, investing plan assets in mortgage loans meeting the above-mentioned union-labor and geographic criteria would not satisfy section 404(a)(1) if such loans would provide the plan with less return, in comparison to risk, than comparable investments available to the plan or if such loans would involve a greater risk to the security of plan assets than other investments offering a similar return.

We have construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in mortgage loans, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement incomes. A decision to make a mortgage loan may not be influenced by a desire to stimulate business in a particular geographic area or to encourage use of union labor unless the loan, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan. The proposed investment by the Separate Accounts in mortgage loans involving union labor and properties located in specified geographic areas may operate to limit potential investment opportunities for the plans whose assets are held in the Separate Accounts. To the extent that the fiduciaries restrict their consideration of investment opportunities for non-economic reasons, we would view such conduct as inconsistent with their duties under section 404(a)(1) of the Act. Please note that both the fiduciaries who make investment decisions on behalf of the Separate Accounts and the independent fiduciaries of each plan who decide to invest part of the plan's assets in a Separate Account are subject to these fiduciary responsibility standards.

If you have any questions, please contact Mrs. Miriam Freund, U.S. Department of Labor, phone number (202) 523-8971.

Sincerely,

Jeffrey N. Clayton
Administrator
Pension and Welfare Benefit Programs

AUG 2 1982

Daniel E. O'Sullivan,
President
Union Labor Life
Insurance Company
850 Third Avenue
New York, NY 10022

Dear Mr. O'Sullivan:

Thank you for the letter from you and your colleague dated July 1, 1982 seeking clarification of a position taken by the Department in previous correspondence with Union Labor Life Insurance Company (ULLICO) regarding the Employee Retirement Income Security Act of 1974 (ERISA). You seek to resolve an issue raised in a June 2, 1980 letter by the then Administrator of the Pension and Welfare Benefit Programs in which it was suggested that the operation of the "J for Jobs" program, a mortgage separate account, might be inconsistent with the requirements of section 404(a)(1) of ERISA.

I have been informed this statement was based on information which was available to the Department - namely that the stated policies of ULLICO were to limit investments in the "J for Jobs" pooled separate account to those projects that were constructed by contractors employing AFL-CIO Building Trades Union members and to direct such account investments back to the geographical areas where they originated. The record reflects that subsequently there were meetings between representatives of the Department and ULLICO to discuss the concerns voiced in the Department's June 2, 1980 letter. In your letter to me you indicate that ULLICO provided statistical data which "demonstrated beyond any doubt that the conduct of the 'J for Jobs' program produced a rate of return which exceeded the industry average and other market indices by substantial margins." You conclude by noting that "no ruling has ever been finalized as to whether, in fact, this Company's 'J for Jobs' program ..." is operated in compliance with the general fiduciary duty rules of section 404 of ERISA.

Section 404(a)(1) of ERISA provides, in relevant part, that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries, defraying reasonable expenses of administering the plan and 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. While this section does not exclude the provision of incidental benefits to others, the protection of retirement income is, and must continue to be, the overriding social objective governing the investment of plan assets. The Department has taken the position that fiduciary considerations such as investment performance may not properly be sacrificed in order to advance the social welfare of a group or region; however, an investment is not impermissible under ERISA solely because it has social utility. If the socially beneficial investment meets objective investment criteria which are appropriate to the goals of a pooled separate account, it may be considered in the same manner as other investments which meet these criteria.

The Department's prior expression of concern was however directed at this aspect of the general fiduciary duty provision of section 404(a)(1) of ERISA. Namely, operating an investment program that rules out certain investments completely. It is difficult to justify an investment policy of exclusion on the basis of non-objective economic investment criteria, whether the exclusion is of union organized companies or non-organized companies, with the ERISA standards that plan assets be managed prudently, solely in the interest of the participants and for the exclusive purpose of paying benefits. Any investment program which for so called social purposes excludes investment possibilities without consideration of their economic and financial merit would, in our view, be inconsistent with ERISA's fiduciary standards. No additional information has been forthcoming from your company which addresses this central concern. Accordingly, I can find no basis for altering the position expressed by the Department in its letter of June 2, 1980.

Sincerely,

Jeffrey M. Clayton
Administrator
Pension and Welfare
Benefit Programs

U.S. Department of Labor

Office of Pension and Welfare Benefit Programs
Washington, D.C. 20210

85-36A

OCT 23 1985

Ralph P. Katz
Delson & Gordon
230 Park Avenue
New York, NY 10169

Re: Annuity Fund of the Electrical Industry of Long Island
Identification Number: F-2521

Dear Mr. Katz:

This is in response to your letter of September 23, 1982, in which you requested clarification regarding the application of the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA) to a proposed investment by the Annuity Fund of the Electrical Industry of Long Island (the Fund). Specifically, you inquired whether a prohibited transaction would occur if the trustees of the Fund made an investment which was part of an overall agreement obligating an insurance company to invest a specified amount of insurance company assets in construction mortgages within the geographic jurisdiction of the union whose members are participants in the Fund. The agreement would further require the insurance company to make such investments in construction projects employing only labor represented by unions affiliated with the AFL-CIO. You state that the trustees will make the investment after determining that the investment rate of return is equal to or greater than similar investments bearing similar risks.

Section 406(a)(1)(D) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction which the fiduciary knows or should know constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) and (2) of ERISA further prohibit a fiduciary with respect to a plan from dealing with the assets of a plan in his or her own interest or for his or her own account, or acting in any transaction on behalf of a party or representing a party whose interests are adverse to the interest of the plan or its participants.

Section 3(14) of ERISA defines the term party in interest to include a fiduciary, an employer any of whose employees are covered by the plan and any employees of such employer.

We wish to point out, as we have done in prior correspondence regarding this matter, that ERISA's general standards of

fiduciary conduct apply to your proposed investment course of action. Sections 403(c) and 404(a)(1) of ERISA require, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. As you know the Department, on a number of occasions, has expressed its views as to the meaning of these requirements in the context of investment decision-making.

We have stated that, to act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan. Because the investment you propose causes the plan to forego other alternative investment opportunities, such an investment would not be prudent if it provided a plan with less return, in comparison to risk, than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.

We have construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment may not be influenced by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan.

Thus, it would not be inconsistent with the requirements of sections 403(c) or 404 of ERISA for plan fiduciaries to select an investment course of action that reflects non-economic factors, so long as application of such factors follows primary consideration of a broad range of investment opportunities that are, economically, equally advantageous.

Based on the representations made in your letter, it does not appear that the arrangement you describe would involve a prohibited transaction of the kind described in sections 406(a)(1)(A), (B) or (C) of ERISA (relating to sales, leases or other exchanges of property, loans or other extensions of credit and the furnishing of goods, services or facilities). In addition, it does not appear that the arrangement involves a direct transfer of plan assets to, or use of plan assets by or for the benefit of, a party in interest of the kind described in section 406(a)(1)(D) of the Act. Nonetheless, it is

reasonable to infer that the arrangement will result in some benefit to parties in interest with respect to the plan, i.e. contributing employers and their employees. Thus, it is necessary to determine whether the arrangement would involve an indirect use of plan assets for the benefit of a party in interest. In the circumstances you describe, where the arrangement would be prohibited, if at all, solely as an indirect use of plan assets for the benefit of a party in interest,*/ the Department believes that it is appropriate to examine the facts and circumstances surrounding the plan's investment to determine whether it is made for the purposes of providing such a prohibited benefit. Since this is an inherently factual determination, the Department is not prepared to issue an advisory opinion regarding the specific arrangement described in your letter. In our view, however, a plan investment which is made subject to a condition which can reasonably be expected to result in a benefit to one or more parties in interest would violate section 406(a)(1)(D) (as well as sections 403 and 404 of the Act) if it involves greater risk or a lesser return to the plan than a comparable transaction that is not subject to such a condition.

This letter constitutes an advisory opinion under ERISA Proc. 76-1. Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Elliot I. Daniel
Assistant Administrator for
Regulations and Interpretations

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*/This kind of arrangement should be distinguished from a plan investment made subject to a condition which in effect makes the transaction an indirect sale or loan.

U.S. Department of Labor

Office of Pension and Welfare Benefit Programs
Washington, D.C. 20210

DEC 18 1985

Mr. William K. Ecklund
Felhaber, Larson, Fenlon and Vogt
900 Conwed Tower
444 Cedar Street
Minneapolis, MN 55101

Re: St. Paul Electric Construction Pension Plan
Exemption Application No. D-6109
Electrical Workers Local 292 Pension Plan and Annuity Plan
Exemption Application No. D-6110
Twin City Carpenters and Joiners Pension Fund
(collectively, the Plans)
Exemption Application No. D-6111

Dear Mr. Ecklund:

The Department of Labor (the Department) has reviewed the above referenced application for exemption from the prohibitions of section 406 of the Employee Retirement Income Security Act of 1974 (the Act) and from the sanctions resulting from the application of section 4975 of the Internal Revenue Code of 1954 (the Code). Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) effective December 31, 1978, the authority of the Secretary of the Treasury to issue rulings and exemptions under section 4975 of the Code, with certain exceptions not here relevant, has been transferred to the Secretary of Labor.

The transaction involves the proposed investment of the Plans' funds in the Mortgage Security Fund R (the Fund), a collective investment fund established by Union Bank and Trust Company of Minneapolis (the Bank), which would then make five year home improvement loans (the Loans), secured generally by residential second mortgages, to parties in interest with respect to the Plans. The interest rate to be charged to borrowers for the Loans would be two and one-half percent above the rate for five year U.S. Treasury Notes at the time the Loan is made. The gross rate of return to the Fund would therefore amount to two and one-half percent above the U.S. Treasury Note rate. The net rate of return to investors in the Fund would be the gross rate less one percent, since one-half percent would be used to pay for Loan insurance and one-half percent would pay the Bank's servicing fee.

On the basis of the facts submitted and representations made, the Department has tentatively decided not to propose the requested exemption.

Among the factors considered in the tentative decision not to propose the requested exemption are:

1) The Department has not been persuaded that the net rate of return to the investors in the Fund represents the fair market rate for similar investments. In this regard, you have provided certain information relating to FNMA second mortgages and FHLMC Home Improvement Loans. You represent that the quoted rate for the FNMA and FHLMC loans represent gross rates of return and that such gross rates do not include servicing and insurance expenses. You further represent that inclusion of such expenses would result in a net rate of return that would be lower than the net rate of return that an investor would receive by investing in the Fund. The Department has been advised, however, that quoted FNMA and FHLMC rates do not represent gross rates of return, but reflect net rates of return to FNMA and FHLMC as investors. Servicing and insurance costs constitute additional expenses which are paid by the borrower. These net rates of return to FNMA and FHLMC as investors appear to be higher than those available for the Plans investing in the Fund.

You also represent that no other financial institutions in the Minneapolis-St. Paul area originate five year loans secured by residential second mortgages. It has come to the Department's attention, however, that other financial institutions in the Minneapolis-St. Paul area do, in fact, originate loans for five years which are secured by residential second mortgages, and which appear to yield a higher rate of return on a net basis to the investor than the rate of return that would be provided to Plans investing in the Fund.

2) In light of the information discussed above and the fact that the Bank is partially owned by several building and construction unions located in the Minneapolis-St. Paul area, the Department is concerned as to whether the Bank would be able to provide the independent judgment and reasoned objectivity required by a plan fiduciary in the decision-making process. In this regard, sections 403(c) and 404(a)(1) of the Act require, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. In deciding whether and to what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors

relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment may not be influenced by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan.

On the basis of the foregoing, the Department is unable to conclude that the requested exemption is in the best interest of the Plans and their participants and beneficiaries.

ERISA Proc. 75-1 (40 FR 18471, April 28, 1975) provides that an applicant is entitled to a conference in Washington, D.C. in the event that the Department contemplates not proposing the requested exemption. If you desire a conference, please notify the Department in writing at the address set forth below, or contact Mr. David Lurie, U.S. Department of Labor, phone (202) 523-8194 to arrange for the time and place of the conference. A request for a conference should be received within 30 days of the date of this letter.

At the conference, you should be prepared to discuss any matter which you believe will support a decision to publish the requested exemption in the FEDERAL REGISTER for comment. Any information or arguments that you want considered with regard to the referenced application should be submitted in writing no later than five days before the scheduled time and date of the conference to the Department of Labor, Office of Pension and Welfare Benefit Programs, Office of Regulations and Interpretations, Room N-5669, 200 Constitution Avenue, N.W., Washington, D.C. 20210.

In the event a request for a conference is not received within 30 days from the date of this letter, you will be notified that a final decision has been made not to propose the requested exemption and that the application file has been closed.

Sincerely,

P. Archibald Straub
Chief
Division of Exemptions

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

May 27, 1986

The Honorable Howard M. Metzenbaum
United States Senate
Washington, D.C. 20510

Dear Senator Metzenbaum:

This is in response to your letter of May 19, 1986, concerning my reported comments to the Council of Institutional Investors, about pension fund divestment in securities of companies doing business in South Africa. The press reports which you cite are accurate descriptions of my comments. However, because you state that my comments are not consistent with prior Department of Labor interpretations of the law, I believe that it may be helpful to more fully explain my comments.

The position I have taken with respect to this issue is the same as has been taken by prior officials of the Department. That position is that, before a fiduciary of an ERISA covered pension plan can make a decision to exclude a category of investments for social purposes, the fiduciary must first make a determination that the exclusion of such category of investments would not reduce the return or raise the risk of the plan's investment portfolio. If such a determination can be made, then social judgments as to the composition of the portfolio would be permissible. In that context, I believe you can understand why I said "an investment policy that is on its face exclusionary runs the risk of being on its face imprudent" because, if the decision to exclude has been made without first doing an economic analysis of the economic consequences to the plan of such exclusion and determining that such an exclusionary policy would not be economically harmful to the plan, the fiduciary making such a decision would be imprudent under ERISA.

I hope these statements more fully explain my position with respect to this matter.

Sincerely,

Dennis M. Kass
Assistant Secretary

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

JUL 14 1986

Mr. Reed Larson
President
National Right to Work Committee
8001 Braddock Road, Suite 500
Springfield, VA 22160

Dear Mr. Larson:

Secretary Brock has asked me to respond to your letter of June 16, 1986, in which you raise a number of concerns with respect to investment of pension funds and, in particular, the application of ERISA to so-called "social investing" practices.

As you are aware, the Department of Labor's Pension and Welfare Benefits Administration is responsible for assuring that private pension funds are handled in accordance with the fiduciary standards embodied in ERISA. The Secretary's letter to you of May 20, 1986, reiterated the Department's position that economic considerations must be controlling insofar as pension fund investments are concerned. As that letter further indicated, where it appears that appropriate scrutiny has been given to the merits of an investment from an economic standpoint, the fact that the investment has been of incidental benefit in achieving another objective would not result in a determination that the investment was inappropriate.

The intent of ERISA's provisions governing fiduciary conduct and the intent of the principles established thereunder is to permit a broad range of investments while assuring that investment decisions are made in the best interests of participants and beneficiaries. We have construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries to unrelated objectives. However, there is nothing in ERISA which would require that the decision to make an investment be wholly uninfluenced by the desire to achieve such objectives, if the investment, when judged solely on the basis of its economic value to the plan, is equal or superior to alternative investments available.

The view that non-economic benefits may be achieved incident to the proper investment of pension funds is one of long standing under both the Internal Revenue Code prior to the passage of

ERISA and under ERISA. Clearly, to prohibit such benefits where the provisions of the law have been scrupulously adhered to would unnecessarily constrain fiduciaries in the exercise of their investment duties. Such a prohibition could result in specific investment opportunities being avoided by fiduciaries simply in order to avoid the possibility of an incidental benefit arising from them.

We appreciate your interest in the Department's activities in the area of pension fund regulation and we trust that we have made the Department's views on the issues which you raised sufficiently clear.

Sincerely,

Dennis M. Kass
Assistant Secretary

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210

SEP 16 1986

Mr. William K. Ecklund
Felhaber, Larson, Fenlon and Vogt
900 Conwed Tower
444 Cedar Street
Minneapolis, MN 55101

Re: St. Paul Electric Construction Pension Plan
Exemption Application No. D-6109
Electrical Workers Local 292 Pension Plan and Annuity Plan
Exemption Application No. D-6110
Twin City Carpenters and Joiners Pension Fund
(collectively, the Plans)
Exemption Application No. D-6111

Dear Mr. Ecklund:

The Department of Labor (the Department) has reviewed the above referenced application for exemption from the prohibitions of section 406 of the Employee Retirement Income Security Act of 1974 (the Act) and from the sanctions resulting from the application of section 4975 of the Internal Revenue Code of 1954.

The transaction involves the proposed investment of the Plans' funds in the Mortgage Security Fund R (the Fund), a collective investment fund established by Union Bank and Trust Company of Minneapolis (the Bank), which would then make five year home improvement loans (the Loans), secured generally by residential second mortgages, to parties in interest with respect to the Plans. The interest rate to be charged to borrowers for the Loans would be two and one-half percent above the rate for five year U.S. Treasury Notes at the time the Loans are made. The gross rate of return to the Fund would therefore amount to two and one-half percent above the U.S. Treasury Note rate. The net rate of return to investors in the Fund would be the gross rate less one percent which reflects one-half percent that would be paid for Loan insurance and one-half percent that would serve as the Bank's servicing fee.

By letter dated December 18, 1985, you were informed that the Department had tentatively decided not to propose the requested exemption. Among the factors considered in the tentative decision not to propose the requested exemption was the failure to adequately demonstrate that the net rate of return to the investors in the Fund represents a return comparable to similar investments otherwise available to the Plans. In this

regard, you provided certain information relating to FNMA second mortgages and FHLMC Home Improvement Loans in support of your claim that the rate of return to the Plans would be at least comparable to the rate of return available from similar loans. On June 12, 1986, you provided additional information comparing the rates of return that would have been earned by Plans investing in the Fund and in FNMA and GNMA securities, as well as a proposal to operate a program such as the Fund by First Bank of St. Paul, that based a second mortgage program on VA mortgage rates. You represent that the information you have provided indicates that the Plans investing in the Fund would earn a rate of return comparable to similar investments available to the Plans.

Based on the information you have submitted, the Department is unable to find that you have provided an objective standard which establishes a basis for the comparison of the rates of return on second mortgages in the Minneapolis-St. Paul area which would indicate that the rate of return to be provided to the Fund represents a fair market rate of return. Accordingly, we are unable to determine that the interest rates on the Loans would provide a fair market rate of return to the Plans for such investments. Therefore, the Department is unable to conclude that the proposed transaction would be in the best interests of the Plans and their participants and beneficiaries, as required under section 408(a) of the Act.

We also note, that with respect to the operation of the Fund in general, the making of loans that would indirectly benefit parties in interest to the Plans, e.g., contributing employers or sponsoring unions, may result in violations of section 406(a)(1)(D) of the Act. Thus, a plan investment which is made subject to a condition which can reasonably be expected to result in a benefit to one or more parties in interest, i.e., the use of loan funds to pay employers who employ only union labor, would violate section 406(a)(1)(D) if it involves a greater risk or a lesser return to the plan than a comparable transaction that is not subject to such a condition.

Should you develop an objective standard that will enable the Department to directly compare the rate of return the Plans will receive on the Loans with the rate of return for second mortgages in the Minneapolis-St. Paul area, the Department will be willing to reconsider your exemption request.

Accordingly, your exemption application will be closed by the Department without further action.

Sincerely,

Elliot I. Daniel
Assistant Administrator
for Regulations and Interpretations

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210

Mr. James S. Ray
Connerton, Ray & Simon
Fourth Floor
1920 L St., N.W.
Washington, D.C. 20036-5004

Re: Union Labor Life Insurance Company
Identification Number: F-3353A

Dear Mr. Ray:

This is in response to your request on behalf of the Union Labor Life Insurance Company (ULLICO) concerning ULLICO's Mortgage Separate Account J (the J Account), a pooled separate account which is designed to invest in mortgages which generally are secured by properties built or improved primarily with union labor. Specifically, your request concerns the application of the fiduciary responsibility provisions of section 404(a)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) to the operation of the J Account in accordance with the structure set forth in your request, and to an employee benefit plan's investment of a portion of its assets in the J Account.

You represent that ULLICO established the J Account in 1977 primarily as a means for plans to invest a portion of their assets in a diversified pool of high quality first mortgages on residential and income-producing properties, earning a return competitive with returns from comparable investments available in the marketplace. ULLICO also designed the J Account incidentally to help support the unionized sector of the building and construction industry. To achieve this incidental goal, ULLICO commits to make mortgages for the J Account which first satisfy rigorous, generally accepted financial standards, and, in addition, which will be secured by properties built or renovated primarily by union labor.1/

1/You note that not all mortgage loans from the J Account are secured by properties built by contractors employing only union labor. The J Account has made (and currently carries) a substantial amount of loans secured by projects located in states with "right-to-work" laws, where statutes prohibit

(Footnote Continued)

You further represent that the underwriting criteria used by ULLICO for both its general account and the J Account conform to those which are recognized as generally accepted by reasonably competent, professional mortgage lenders. ULLICO solicits and receives loan proposals from a variety of sources, including borrowers and developers, brokers, mortgage bankers, unions and designated correspondents.2/ ULLICO receives such proposals from parties intending to utilize non-union labor as well as parties intending to use only union labor. You have indicated, however, that most of those who apply to ULLICO for loans are aware of ULLICO's union-only condition, and that ULLICO officials may mention this condition to applicants who might not otherwise be aware of it.

Initially, the Mortgage Department of ULLICO originates possible investment opportunities, elicits written mortgage loan applications and submissions, performs the underwriting, negotiates acceptable loan terms and prepares a summary of the proposed mortgage and recommendation for presentation to ULLICO's Mortgage Subcommittee. Next, ULLICO's financial vice president typically reviews the proposal, with particular attention to certain financial factors, such as the financial statements and credit worthiness of the proposed borrower. In a third phase of the process, the Mortgage Subcommittee, a subcommittee of the Finance and Investment Committee of the Board of Directors of ULLICO, reviews the proposal and recommendation, and approves or rejects the loan. Finally, the full Executive Committee ratifies the approval of the Mortgage Subcommittee.

ULLICO considers a broad range of physical, economic, financial and related factors with respect to all loans for its general account and the J Account. Those factors include:

(1) Location of the property which will secure the loan;

(Footnote Continued)
enforceable agreements requiring the use of only union tradesmen. However, in such states, ULLICO requires the borrower to agree to use only contractors who are signatory to collective bargaining agreements with unions affiliated with the local AFL-CIO Building Trades Council. Finally, some portions of the projects which the J Account has financed may have been undertaken by non-union companies and workers, where, for example, union tradesmen are not available.

2/You represent that any transactions between the J Account and a party in interest with respect to a plan investing in the J Account would be exempted from the restrictions of section 406(a) of ERISA by Prohibited Transaction Exemption 78-19 (43 FR 59915, December 22, 1978).

(2) Description of the security;

(3) Valuation of the security - loans secured by income-producing property do not exceed a loan to value ratio of 75 percent;

(4) Ability to repay - ULLICO considers a number of factors including the borrower's track record and income and expense projections with respect to the proposed project;

(5) Terms of the loan; and

(6) Diversification - by geography, size of loans, type of properties and type of tenants.

Upon approval of a proposed loan by the Mortgage Subcommittee, ULLICO prepares and issues a commitment letter, setting forth the terms and conditions of the proposed loan. The borrower signifies acceptance by signing the commitment and paying the commitment fee. The union labor condition is included in the loan commitment. You represent that ULLICO will not commit to or fund a mortgage loan which does not meet its investment criteria, regardless of the requirement to use union labor. The promise of a borrower or developer to use union labor will not cause ULLICO to waive or compromise the requirements which all its investments must satisfy.

Sections 403(c) and 404(a)(1) of ERISA require, among other things, that a fiduciary of a plan act prudently, solely in the interests of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries.

It is the position of the Department that, to act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan. Because the mortgage loans which the J Account makes causes it to forego other investment opportunities, such a loan would not be prudent if it provided the investing plans with less return, in comparison to risk, than comparable investments available to the plans, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.

The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors relating to the interests of plan

participants and beneficiaries in their retirement income. A decision to make an investment may not be influenced by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan.

Thus, it would not be inconsistent with the requirements of sections 403(c) and 404 of ERISA for the J Account to make loans on properties which are constructed or improved with union labor, so long as the J Account's investment process assures that loans made by the J Account will be at prevailing market terms, i.e., that the terms for projects with the union-only condition in fact reflect the terms prevailing in the overall mortgage market. In this regard, we wish to point out that if mortgage loans which satisfy both ERISA's fiduciary standards and the union-only condition are unavailable for investment by the J Account, the prudence and exclusive purpose requirements of sections 403(c) and 404 of ERISA would require that the fiduciaries of the J Account select comparable investment opportunities which are available to the Account.

We trust that this information will be helpful to you.

Sincerely,

Robert J. Doyle
Acting Director of
Regulations and Interpretations

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210

88-16A
Sec. 403(c), 404(a)(1)

DEC 19 1988

Mr. Gregory Ridella
Chrysler Corporation
P.O. Box 1919
Detroit, MI 48288

Re: Chrysler Corporation and the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America
Identification Number: F-3674A

Dear Mr. Ridella:

This is in response to your letter of July 7, 1986, in which you request, on behalf of the Chrysler Corporation (Chrysler) and the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW), an advisory opinion under the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, you request an opinion that a certain understanding contained in a Letter Agreement between Chrysler and the UAW with respect to Chrysler's Pension Fund (the Plan) does not violate the aforementioned provisions of ERISA. The Letter Agreement is substantially similar to one entered into in 1979 by Chrysler and the UAW.

You have represented that the Plan's assets are held in trust and that its investments are exclusively managed by investment managers. In order to assist the investment managers by providing an expanded range of information concerning investment opportunities, Chrysler and the UAW agreed to establish an Investment Advisory Committee (the Committee) consisting of three members appointed by Chrysler and three members appointed by the UAW. The powers and authority of the Committee are limited to (1) selecting and recommending to the Plan's investment managers communities in which residential mortgage financing could be made available by the Plan, and (2) annually recommending to the investment managers opportunities for investments in debt obligations of nonprofit nursing homes, nursery schools, federally qualified health maintenance organizations, hospitals or similar nonprofit institutions.

At least two members of the Committee appointed by Chrysler and two appointed by the UAW shall be required to constitute a quorum for any Committee meeting. Decisions of the Committee

shall be by a majority of votes cast. In the event of a tie vote, the matter shall be referred to the Impartial Chairman of the Appeal Board under the collective bargaining agreement applicable to production and maintenance employees of Chrysler, who shall cast the deciding vote. In addition, the Committee members serve without compensation.

The new Letter Agreement is substantially the same as its predecessor. The understanding between Chrysler and the UAW is that up to 5% (as opposed to 10% under the old agreement) of Chrysler's annual contribution to the Plan that is available for investment after deducting the portion of the benefits payable under the Plan for the year which is in excess of the investment income earned by the Plan may be invested in (1) residential mortgages in communities where there are substantial numbers of UAW members, and (2) debt obligations of nonprofit institutions described above located in communities where there are large concentrations of UAW members. As mortgages and debt obligations are amortized, the principal portion of such payments to the Plan will be considered as amounts available for further investment in such mortgages and debt obligations.

Under the Letter Agreement, it was also agreed that the UAW may submit to the investment managers of the Plan annually a list of not more than ten companies (increased from five under the old agreement) which conduct business in South Africa but which have not supported the elimination of racial discrimination in South Africa through their endorsement of Leon H. Sullivan's "Amplified Guidelines to South African Statement of Principles" dated May 1, 1979, with the recommendation that the investment managers refrain from investing any of the funds of the Plan in the securities of such companies. Such recommendation shall not apply with respect to any assets of the Plan that are invested in interests in a common or collective trust fund or pooled investment fund maintained by any of the investment managers or to any insurance contract constituting an asset of the Plan.

Under the Agreement, the investment managers of the Plan shall exercise investment judgment with respect to recommendations received by them from the Committee and the UAW. The investment managers have the responsibility to secure, over the long term, the maximum attainable total return on investment consistent with the principles of sound, prudent pension fund management. They are expected to discharge their duties solely in the interest of Plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries, to avoid prohibited transactions, and to meet all other fiduciary responsibilities imposed by ERISA or other applicable law. Also, they are expected to discharge their duties 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 a conduct of an enterprise of a like character and with like aims. It is intended that the investment managers of the Plan shall continue to have full investment discretion. Accordingly, if, in the judgment of the investment managers, any recommendation of the Committee or the UAW should not be implemented because in the exercise of their investment responsibilities they conclude that the recommended action is not appropriate or it otherwise does not meet the standards of prudence required or is not consistent with the fiduciary obligations and responsibilities of the investment managers, they shall not implement the request and shall so inform the Committee or the UAW.

Chrysler and the UAW have agreed not to attempt to influence the investment managers regarding any specific recommendations of the Committee or the UAW.

Section 406(a)(1)(A) and (B) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction, if he or she knows or should know that such transaction constitutes a direct or indirect sale or exchange, or leasing, of any property, or lending of money or other extension of credit between the plan and a party in interest with respect to the plan. Section 406(a)(1)(D) prohibits a transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan.

Section 406(b)(1) and (2) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account, or acting in his or her individual or in any other capacity in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or its participants or beneficiaries.

Section 3(14) of ERISA defines a party in interest with respect to a plan to include a fiduciary and an employee of an employer any of whose employees are covered by the plan.

Sections 403(c) and 404(a)(1) of ERISA require, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries.

We have stated that, to act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his or her plan. Because the investments you propose to recommend for the Plan would, if implemented, cause the Plan to forego other

investment opportunities, such investments would not be prudent if they provided a plan with less return, in comparison to risk, than comparable investments available to the plan, or if they involved a greater risk to the security of plan assets than other investments offering a similar return.

We have construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment may not be influenced by non-economic factors unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan.

You have represented that, pursuant to the Letter Agreement concerning investment in certain mortgages and non-profit entities, the recommendations of the Committee and the UAW are advisory only, and that the investment managers retain exclusive discretion with respect to investment decisions. To the extent that the Committee merely brings investment opportunities to the attention of the investment managers which, although perhaps not generally explored by certain traditional investment managers, may nonetheless be prudent and potentially profitable, it appears to the Department that the use of the Committee concept contained in the Letter Agreement would not be inconsistent with the requirements of sections 403(c) and 404(a)(1) of ERISA.

Similarly, it appears that the recommendations of the UAW regarding companies which conduct business in South Africa and which have not endorsed the so-called "Sullivan Principles" are merely advisory in nature and, thus, will not inappropriately limit the investment alternatives available to the Plan's investment managers. Accordingly, it is the Department's opinion that such recommendations made in accordance with the Letter Agreement would not be inconsistent with the requirements of section 403(c) and 404(a)(1) of ERISA. However, the Department emphasizes that it is not expressing an opinion as to how the understanding contained in the Letter Agreement will, in fact, operate; nor are we expressing an opinion concerning whether specific transactions undertaken in accordance with the Letter Agreement would be consistent with the requirements of sections 403(c)(1) and 404(a)(1) of ERISA.

With regard to the application of the prohibited transaction provisions to the understanding contained in the Letter Agreement, the Department notes that your request has not identified any specific transactions that will be undertaken

in accordance with the Agreement.*/ Accordingly, we are unable to determine if any violations of section 406 would occur. The determination of whether a particular transaction is prohibited by the provisions of sections 406(a) and 406(b) must be made by the appropriate plan fiduciaries.

This letter constitutes an advisory opinion under ERISA Proc. 76-1. Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Robert J. Doyle
Director of Regulations
and Interpretations

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*/We note that the Letter Agreement indicates that loans may be made to UAW members. In the absence of a statutory or administrative exemption, loans to parties in interest including employees of the plan sponsor would be prohibited under section 406 of ERISA. We note, however, that section 408(b)(1) exempts from the prohibitions of section 406 loans made by the plan to parties in interest who are participants or beneficiaries of the plan if all of the conditions of that section are met. We further note that certain arrangements may involve a use of plan assets for the benefit of a party interest in violation of section 406(a)(1)(D) of ERISA. In this regard, See Advisory Opinion 85-36 (October 23, 1985).

U.S. DEPARTMENT OF LABOR

SECRETARY OF LABOR
WASHINGTON, D.C.

NOV 23 1990

The Honorable Jack Kemp
Secretary of Housing and Urban Development
Washington, D.C. 20410

Dear Jack:

Thank you for your letter discussing the New York City Housing Partnership proposal to use pension funds to subsidize housing for low and moderate income families in New York City.

I am, of course, totally supportive of efforts to make housing more affordable to the working men and women of America. I strongly supported legislation amending the Labor Management Relations Act to permit labor unions to bargain for financial assistance for employee housing. This provision, enacted last April, has already been put to use. Local 26 of the Hotel Restaurant Workers Union in Boston believes that this legislation represents a positive private sector solution to the problem of affordable housing. The local has established a housing trust fund to pay initial rent deposits, downpayments on homes, supplemental mortgage payments, and mortgage insurance. In addition, the Department of Labor has worked with the building and construction trades unions to structure a program that allows their pension funds to invest in housing construction.

While I am open to considering creative proposals that make housing more affordable, I am also vested with the responsibility of protecting more than 40 million pension participants who depend on sound pension plans for their retirement security. A basic tenet of ERISA's fiduciary provisions is that a pension plan may not accept a lower rate of return than is appropriate given the degree of risk involved. Virtually every year since ERISA was enacted, one group or another has come forth with proposals to have pension plans invest at below market rates of return in order to achieve what is perceived as greater social benefit.

For example, in June of 1989, a task force set up by New York's Governor Cuomo issued a report on pension fund investments that recommended a new standard for measuring fiduciary duties that would provide "optimal" returns so as "to serve the multiple interests of beneficiaries, generate proper, risk-adjusted economic returns, and create benefits for other stakeholders." Under this rubric the report proposed that New York State provide technical assistance to pension funds to identify investment strategies "that provide more housing, jobs, and other forms of economic growth and increased competitiveness."

As I understand the proposal you outlined in your letter, the Housing Partnership proposes that pension plans provide an advance commitment to invest in Fannie Mae securities backed by insured mortgages of up to 40 years that are priced to yield approximately two percentage points below that available on conventional mortgage-backed securities.

In analyzing the New York City Housing Partnership's proposal, a determination would have to be made as to whether federal or state insurance of the mortgages comprising the Fannie Mae pool would justify a two percent reduction of return over a 40-year period. It is difficult to imagine plan fiduciaries choosing these investments when other mortgage securities which have no default risk and carry a higher interest rate, such as Ginnie Maes, are available.

The problem with such approaches lies in the economic cost to pension funds of such subsidies. Workers and their employers are being asked to subsidize housing construction by taking a lower rate of return on their retirement savings. Lower returns would increase the cost of providing privately-sponsored pension benefits which are crucial to an aging population. Over the long term such increased costs could actually result in reduced pension benefits. Such proposals could also result in a less productive allocation of the largest source of capital to the nation's financial markets, possibly impairing long-term productivity and economic growth. For these reasons, the Department cannot change its interpretation of ERISA to allow investments at below market rates of return.

You and I are both committed to advancing homeownership and affordable housing through any innovative and prudent means possible. I know that you also share my concern that the integrity of pension promises made to workers and retirees must also be maintained.

With my warmest regards,

Sincerely,

Elizabeth R

Elizabeth Dole

3 02:22PM FROM PWBA DAS TO IVAN STRASFELD P004

file - Kemp
social cmtes

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

JAN 30 1991

Mr. Preston Robert Tisch
Chairman
New York City Partnership, Inc.
One Battery Park Plaza
New York, NY 10004-1405

Dear Mr. Tisch:

Thank you very much for your recent letters to me and Secretary-Designate Martin regarding the New York City Housing Partnership. As you pointed out in your letter, at the request of HUD Secretary Kemp, former Secretary Dole considered the proposal for the participation of ERISA covered pension funds in the Partnership's Affordable Mortgage Program.

In her response to Secretary Kemp dated November 23, 1990, Secretary Dole noted that the Department of Labor (Department) has worked with the Congress, the building and construction trade unions, and other interested parties to structure programs that permit pension funds to invest in housing in a manner consistent with ERISA's fiduciary responsibility requirements. Since the enactment of ERISA in 1974, the Department has consistently stated its position that ERISA's rules are flexible enough to permit plans to invest in areas of the economy that are most appropriate for each individual plan's circumstances. In fact, our regulations under section 404(a)(1)(B) of ERISA, which defines the statute's prudence standard, adopted a broad interpretation of that term precisely for the purpose of encouraging plan fiduciaries to look beyond the traditional types of trust investments. It is axiomatic, however, that plan fiduciaries, in order to be prudent, must achieve a rate of return that is appropriate for the degree of risk involved. To do otherwise would, in effect, subsidize certain investment at the expense of market place discipline.

With these basic principles in mind, I would be happy to meet with you to discuss the ERISA issues relating to the New York City Housing Partnership. If you think such a meeting would be useful, please contact my office at (202) 523-8233 to arrange a mutually convenient date and time.

Sincerely,

David George Ball

David George Ball
Assistant Secretary

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington D.C. 20210

May 14 1993

Mr. Stuart Cohen
General Motors Corporation
Legal Staff
New Center One Building
3031 West Grand Boulevard
P.O. Box 33122
Detroit, MI 48232

Dear Mr. Cohen:

This is in response to your request for an advisory opinion, on behalf of General Motors Corporation (GMC), under the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, you request an opinion that a certain understanding contained in a Letter Agreement (the Agreement) between GMC and the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) with respect to the General Motors Hourly Rate Employees Pension Plan (the Plan) does not violate Part 4 of Title I of ERISA.

According to your request, the Agreement provides that up to five percent of GMC's annual contribution to the Plan that is available for investment, after deducting the portion of benefits payable in such year in excess of the investment income, may be invested in residential mortgages and in debt instruments of certain non-profit organizations by the trustees and investment managers of the Plan. The residential mortgages, which consist of mortgages on single and multiple dwellings in communities with substantial numbers of UAW members, will be available to the general public, including UAW members, at rates and upon terms prevailing in the respective communities. The purchase price of the dwellings shall not exceed the market price of 90 percent of similar housing in that community. The debt obligations are of non-profit institutions including nursing homes, nursery schools, federally-qualified health maintenance organizations, and hospitals or similar non-profit institutions in communities with substantial numbers of UAW members. The UAW may submit annually a list of specific non-profit institutions.

Under the Agreement, the parties also agreed that the UAW may submit to GMC annually a list of not more than seven

companies with the recommendation that the Plan forego investments in the securities of such companies. The list may include companies which conduct business in South Africa but which have not supported the elimination of racial discrimination in South Africa through their endorsement of Dr. Leon H. Sullivan's "Amplified Guidelines to South Africa Statement of Principles" dated May 1, 1979. The recommendation shall not apply with respect to any assets of the Plan that are invested in interests in common or collective trust funds or pooled investment funds maintained by any of the Plan's investment managers or any insurance company.

Under the Agreement, the investment managers of the Plan shall continue to have full investment discretion including discretion with respect to decisions regarding the recommendations received by them from the UAW through GMC. In this regard the Agreement confirms that the investment managers have the responsibility to secure, over the long term, the maximum attainable total return on investment consistent with the principles of sound, prudent pension fund management. The Agreement further states that investment managers are expected to discharge their duties solely in the interest of Plan participants and beneficiaries for the exclusive purpose of providing benefits to participants and their beneficiaries, to avoid prohibited transactions, and to meet all other fiduciary responsibilities imposed by ERISA. Accordingly, if, in the judgment of the investment managers, any recommendation of the UAW should not be implemented because they conclude that the recommended action is not appropriate or is not consistent with their fiduciary obligations and responsibilities, they shall not implement the request.

The funds of the Plan, in addition to the funds of all of the other GMC pension plans, are managed under the direction of the Named Fiduciary which is the Finance Committee of the General Motors Board of Directors. The Named Fiduciary has delegated authority to invest the Plan's funds to approximately 70 outside investment managers except for a small portion which is invested in-house by the Investment Funds Activity of General Motors. The Agreement applies to Plan funds designated for either outside or in-house investment management.

ERISA Procedure 76-1 (41 FR 36281, August 27, 1976) sets forth the general procedures for obtaining advisory opinions and information letters from the Department of Labor (the Department). Pursuant to section 5.02 of ERISA Procedure 76-1,

the Department may, when it is deemed appropriate and in the best interest of sound administration of ERISA, issue information letters calling attention to established principles under ERISA. In this regard, we have determined that it is appropriate to respond to your inquiry in the form of an information letter, which is described in section 3.01 of the Procedure.

Section 406(a)(1)(A) and (B) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction, if he or she knows or should know that such transaction constitutes a direct or indirect sale or exchange, or leasing, of any property, or lending of money or other extension of credit between the plan and a party in interest with respect to the plan. Section 406(a)(1)(D) prohibits a transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 3(14) of ERISA defines a party in interest with respect to a plan to include a fiduciary and an employee of an employer any of whose employees are covered by the plan. Section 3(21) of ERISA defines a fiduciary with respect to a plan to include an investment manager.

Section 406(b)(1) and (2) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account, or acting in his or her individual or in any other capacity in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or its participants or beneficiaries.

Sections 403(c) and 404(a)(1) of ERISA require, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries.

The Department has stated that, to act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his or her plan. Investments proposed for recommendation to a plan, which would if implemented cause a plan to forego other investment opportunities, would not be prudent if they provided the plan with less return, in comparison to risk, than comparable investments available to the plan, or if they involved a greater risk to the security of plan assets than other investments offering a similar return.

The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive

purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make, or not to make, an investment may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative available investments. However, it would not be inconsistent with the requirements of sections 403(c) or 404 of ERISA for plan fiduciaries to follow an investment course of action that reflects non-economic factors, so long as application of such factors follows primary consideration of a broad range of investment opportunities, and the investment course of action ultimately taken is as at least as economically advantageous as any alternative course of action.

We note that the Department has previously addressed issues similar to those you raise in Advisory Opinion 88-16A (December 19, 1988)(copy enclosed). That case involved a letter agreement between Chrysler Corporation and the UAW which provided for recommendations with regard to investing in residential mortgages and debt obligations of non-profit organizations as well as foregoing investments in specified companies due to their conduct of business in South Africa and failure to endorse the "Sullivan Principles." The recommendations were merely advisory and the investment managers retained exclusive discretion with regard to investments. The Department opined that the recommendations made in accordance with the letter agreement would not be inconsistent with the requirements of sections 403(c) and 404(a)(1) of ERISA. However, the Department did not opine as to how the understanding contained in the letter agreement would, in fact, operate nor whether specific transactions undertaken in accordance with the letter agreement would be consistent with the requirements of sections 403(c)(1) and 404(a)(1) of ERISA.

With regard to the application of the prohibited transaction provisions, the Department notes that your request has not identified any specific transaction that will be undertaken. We wish to point out that the determination of whether a particular

transaction is prohibited by the provisions of sections 406(a) and 406(b) must be made by the appropriate plan fiduciaries.*

I hope that this information is of assistance to you.

Sincerely,

Mark A. Greenstein
Acting Chief, Division of
Fiduciary Interpretations
Office of Regulations and
Interpretations

* We note that the Agreement in your request indicates that loans may be made to UAW members. In the absence of a statutory or administrative exemption, loans to parties in interest including employees of the plan sponsor would be prohibited under section 406 of ERISA. We note, however, that section 408(b)(1) exempts from the prohibitions of section 406 loans made by the plan to parties in interest who are participants or beneficiaries of the plan if all of the conditions of that section are met. We further note that certain arrangements may involve a use of plan assets for the benefit of a party in interest in violation of section 406(a)(1)(D) of ERISA. In this regard, see Advisory Opinion 85-36 (October 23, 1985).

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

OCT 6 1993

Mr. Rodney Hilton Brown
President
U.S. Select Management, Inc.
156 West 56th Street, 11th Floor
New York, New York 10019

Dear Mr. Brown:

This responds to your further inquiry regarding whether it would be permissible for pension plans covered by Title I of the Employee Retirement Income Security Act of 1974 (ERISA) to invest in the Targeted Neighborhood Trusts (TNT) Program.

As we previously advised you, under ERISA, pension plans must make investments based on their own needs. In this regard, the Department has adopted regulations (copy enclosed) which interpret ERISA's "prudence" requirement. The regulations are based on the proposition that the prudence of any investment should be judged in relation to the role which the proposed investment is to play in a particular plan's portfolio. The regulations do not make any determination with respect to the prudence of any specific investments, nor do the regulations prohibit, out of hand, any investments. Accordingly, the Department does not maintain a list of "permissible" investments, nor do we opine on whether a specific proposed investment is prudent.

Moreover, as you can appreciate, it would not be appropriate for the Department to generally endorse one particular product as a permissible or prudent investment for plans. Therefore, regardless of how your request is formulated, we regret that we are unable to provide you with a general confirmation that the TNT Program is a permissible pension plan investment.

Sincerely,

Olena Berg

Enclosure

Pension and Welfare Benefit Programs

[Prohibited Transaction Exemption 84-25; Exemption Application No. D-3706 et al.]

Grant of Individual Exemptions; Pacific Coast Roofers Pension Plan et al

AGENCY: Pension and Welfare Benefit Programs, Labor.

ACTION: Grant of Individual Exemptions.

SUMMARY: This document contains exemptions issued by the Department of Labor (the Department) from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

Notices were published in the Federal Register of the pendency before the Department of proposals to grant such exemptions. The notices set forth a summary of facts and representations contained in each application for exemption and referred interested persons to the respective applications for a complete statement of the facts and representations. The applications have been available for public inspection at the Department in Washington, D.C. The notices also invited interested persons to submit comments on the requested exemptions to the Department. In addition the notices stated that any interested person might submit a written request that a public hearing be held (where appropriate). The applicants have

84-25
D-3706

PAGE 13771

represented that they have complied with the requirements of the notification to interested persons. No public comments and no requests for a hearing, unless otherwise stated, were received by the Department.

This notices of pendency were issued and the exemptions are being granted solely by the Department because, effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type proposed to the Secretary of Labor.

Statutory Findings

In accordance with section 408(a) of the Act and/or section 4975(c)(2) of the Code and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 25, 1975), and based upon the entire record, the Department makes the following findings:

(a) The exemptions are administratively feasible;

(b) They are in the interests of the plans and their participants and beneficiaries; and

(c) They are protective of the rights of the participants and beneficiaries of the plans.

Pacific Coast Roofers Pension Plan (the Plan) Located in San Jose, California

[Prohibited Transaction Exemption 84-25; Exemption Application No. D-3706]

Preamble

In granting this exemption, the Department notes that it is not making any determination regarding the merits of the proposed transactions as investments for the Plan.

Exemption

The restrictions of section 406(a)(1)(D) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(D) of the Code, shall not apply to the proposed use of Plan assets for the benefit of contributing employers to the Plan, pursuant to a revolving loan program to be entered into between the Plan and Union Bank.

For a more complete statement of the facts and representations supporting the Department's decision to grant this exemption refer to the notice of proposed exemption published on September 23, 1983 at 48 FR 43420.

For further information contact: Richard Small of the Department, telephone (202) 523-7222. (This is not a toll-free number.)

PAGE 13772

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) These exemptions are supplemental to and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(3) The availability of these exemptions is subject to the express condition that the material facts and representations contained in each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, D.C., this 3rd day of April 1984.

Elliot I. Daniel,

Acting Assistant Administrator for Fiduciary Standards, Office of Pension and Welfare Benefit Programs, U.S. Department of Labor

[FR Doc. 84-9277 Filed 4-5-84; 8:45 am]

BILLING CODE 4510-29-M

[1] Since Dr. Bergmann is the sole stockholder of Martin Bergmann, M.D., Inc. (the Employer) and the only participant in the Plans, there is no jurisdiction under Title I of the Act pursuant to 29 CFR 2510.3-3(b). However, there is jurisdiction under Title II of the Act pursuant to section 4975 of the Code.

D-3706
1983

Employee Benefit Plans; Prohibited Transaction Exemptions; Proposed Exemptions; Pacific Coast Roofers Pension Plan

SUMMARY: This document contains notices of pendency before the Department of Labor (the Department) of proposed exemptions from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

Written Comments and Hearing Requests

All interested persons are invited to submit written comments or requests for a hearing on the pending exemption, unless otherwise stated in the Notice of Pendency, within 45 days from the date of publication of this Federal Register Notice. Comments and requests for a hearing should state the reasons for the writer's interest in the pending exemption.

ADDRESS: All written comments and requests for a hearing (at least three copies) should be sent to the Office of Fiduciary Standards, Pension and Welfare Benefit Programs, Room C-4526, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, D.C. 20216. Attention: Application No. stated in each Notice of Pendency. The applications for exemption and the comments received will be available for public inspection in the Public Documents Room of Pension and Welfare Benefit Programs, U.S. Department of Labor, Room N-4677, 200 Constitution Avenue, NW., Washington, D.C. 20216.

Notice to Interested Persons

Notice of the proposed exemptions will be provided to all interested persons in the manner agreed upon by the applicant and the Department within 15 days of the date of publication in the Federal Register. Such notice shall include a copy of the notice of pendency of the exemption as published in the Federal Register and shall inform interested persons of their right to comment and to request a hearing (where appropriate).

SUPPLEMENTARY INFORMATION: The proposed exemptions were requested in applications filed pursuant to section 408(a) of the Act and/or section 4975(c)(2) of the Code, and in accordance with procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). Effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type requested to the Secretary of Labor. Therefore, these notices of pendency are issued solely by the Department.

The applications contain representations with regard to the proposed exemptions which are summarized below. Interested persons are referred to the applications on file with the Department for a complete statement of the facts and representations.

Pacific Coast Roofers Pension Plan (the Plan) Located in San Jose, California

[Application No. D-3706]

Proposed Exemption

The Department is considering granting an exemption under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). If the exemption is granted the restrictions of section 406(a)(1)(D) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(D) of the Code, shall not apply to the proposed use of Plan assets for the benefit of contributing employers to the Plan, pursuant to a reroofing loan program to be entered into between the Plan and Union Bank (the Bank).

Summary of Facts and Representations

1. The Plan, which covers workers in the roofing industry, is a multiemployer defined benefit plan established in accordance with section 302(c)(5) of the Labor Management Relations Act of 1947, as amended. The Plan currently has approximately 4,100 participants and approximately $35 million in net assets. The Plan is administered by a board of trustees (the Trustees) with an equal number of Trustees representing labor and management. The Trustees have delegated full investment management authority and responsibility under section 402(c)(3) of the Act to McMorgan & Company (McMorgan) as the Plan's investment manager (as defined in section 3(38) of the Act). McMorgan is an investment

advisor registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. McMorgan currently has approximately $2 billion in assets of approximately 47 employee benefit plans under management.

2. The Plan proposes to invest $3 million in certificates of deposit issued by the Bank, which has no current relationship with the Plan. McMorgan is authorized to make additional allocations to the program if it determines that such deposits are in the best interests of the Plan. However, such additional deposits, when added to the initial $3 million allocation, will not exceed 10% of the total value of the Plan's assets at the time of any such additional allocation. The Bank will subsequently make loans (the Loans) from its own funds to customers who meet the Bank's normal lending standards for similar loans, to finance residential reroofing jobs, provided the work is done by employers who are required under collective bargaining agreements to contribute to the Plan on behalf of the employees who would do the reroofing work.

3. The terms and conditions of the proposed agreement with the Bank are embodied in a written agreement (the Deposit Agreement). The Plan's $3 million deposit will be initially invested in a master certificate of deposit (Master CD) at the Bank's regular 30-day rate for large certificates of deposit, subject to adjustment higher or lower each month.

4. At the end of each month, funds would be transferred from the Master CD to certificates of deposit (Funding CD's) in the amount of the Loans made in that month. Due to banking restrictions, the amount of each Funding CD must be no less than $100,000. If Loans are made in an amount which is less than $100,000 in a particular month, $100,000 will nevertheless be transferred to a Funding CD, but no further amounts will be transferred to a Funding CD until the full $100,000 in Loans has been made in future months. The interest rate on the entire Funding CD would remain the same despite the fact that Loans (all of which would have a term of the same length as the term of the Funding CD) may be made in subsequent months at differing interest rates. Both the Loans and the Funding CD's would initially have terms of two years but could have terms of one or three years in the future.

5. The rate of interest on the Funding CD's will be equal to the average rate charged by the Bank under the Loans in the month that the Funding CD was purchased minus 4.42%.

The 4.42% deduction represents the Bank's compensation for its origination, servicing and assumption of the risk of loss with respect to the Loans. The maximum rate of interest the Bank may charge on the Loans is limited by the Usruh Act (California Civil Code § 1801 et seq.) under which the maximum interest rate is 16.42%. Therefore, the current maximum interest rate on a Funding CD would be 12% which would yield 12.68% on an annual basis.

6. The minimum Funding CD rate for an upcoming month will be set at a figure no less than 25 basis points below the effective annual yield at the end of the preceding month on comparable, insured fixed-income investments issued by other issuers which have maturities and dates of issue comparable to those available through the program. While McMorgan expects that in most instances the minimum Funding CD interest rate specified for any month will be equal to or greater than the rates available on comparable, insured fixed-income investments at the end of the preceding month unreduced by 25 basis points, McMorgan represents that the 25 basis points measure of flexibility will allow it to exercise its expertise as an investment manager to anticipate changes in interest rates and to obtain for the Plan a Funding CD rate based on the anticipated change. For example, if at the end of a month McMorgan expects that interest rates will decline during the coming month, but it does not have the authority to fix a minimum Funding CD interest rate lower than the current interest rate on comparable, insured fixed-income investments, the Plan might lose the opportunity to invest in a Funding CD which would have an interest rate (and effective annual yield) equal to or greater than that of the comparable investment issued at the end of the month for which the minimum rate was specified.

7. McMorgan has the responsibility to monitor the Plan's participation in the program and to evaluate whether or not it is in the best interest of the Plan to continue or suspend its participation in the program. Under the terms of the Deposit Agreement the Plan has the right: a) to inform the Bank prior to the beginning of a month of the minimum acceptable interest rate it will accept on a Funding CD issued in respect of Loans made during the month; b) to suspend the transfer of assets from the Master to a Funding CD in any month by giving notice to the Bank prior to the beginning of the month; and c) to terminate its participation in the program on 15 days' written notice to the Bank (upon termination, all Master and Funding CD's would continue until their maturities, at which time they would be paid by the Bank to the Plan).

8. When, in the judgment of McMorgan, the expected rate of return on Funding CD's issued through the program will not equal or exceed the rates available to the Plan on comparable, insured fixed-income investments for any significant period of time, McMorgan will suspend or terminate the Plan's participation in the program. In determining whether to suspend or to terminate the Plan's participation in the program, McMorgan will apply its expertise to assess how long the interest rates on Funding CD's available under the program are likely to remain below rates available on comparable, insured fixed-income investments. During a period of suspension, no new transfers from the Master CD to a Funding CD would be made except for Loans made prior to the suspension date.

9. McMorgan might also determine, in the context of its review of the Plan's allocation of assets among fixed-income and other types of investments or among certificates of deposit and other forms of fixed-income investments, that it would be in the interest of the Plan to reduce its investments in certificates of deposit. Such a determination would also enter into McMorgan's consideration of whether to suspend or terminate the Plan's participation in the program.

10. McMorgan has invested the Plan's assets in a broadly diversified portfolio of fixed-income securities, common stocks and real estate investments. In connection with the program of investments described in the application, McMorgan has evaluated the Plan's portfolio of fixed-income investments and has determined that the investment at this time of $3 million in insured certificates of deposit having rates of return which would be equal to or greater than those available in comparable, insured fixed-income investments would be an appropriate investment for the Plan. McMorgan has also determined that the purchase of Master and Funding CD's through participation in the program and under conditions that it will be monitoring, is consistent with the investment policy of the Plan and in the best interests of the Plan's participants and beneficiaries. This determination is supported by McMorgan's assessment of the economic merits of the investments without regard to any benefits accruing to the Plan or its participants and beneficiaries as a result of increased employment opportunities and employee contributions that may be generated by the program.

11. In summary, the applicant represents that the proposed

transactions satisfy the statutory criteria of section 408(a) due to the following:

(a) McMorgan, the Plan's independent investment manager, has reviewed the investment program described herein and believes that it is in the Plan's interest based solely on the economic and financial merits of the Plan's involvement in the program; and

(b) McMorgan will act on the Plan's behalf regarding the Plan's investment in Master and Funding CD's and will monitor all transactions relating to such investment.

For further information contact: Mr. Robert Sandler of the Department, telephone (202) 523-8196. (This is not a toll-free number.)

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) Before an exemption may be granted under section 408(a) of the Act and/or section 4975(c)(2) of the Code, the Department must find that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries and protective of the rights of participants and beneficiaries of the plan; and

(3) The proposed exemptions, if granted, will be supplemental to, and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(4) The proposed exemptions, if granted, will be subject to the express condition that the material facts and representations contained in each application are true and complete, and that each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, D.C., this 13th day of September 1983.

Jeffrey N. Clayton,

Administrator, Pension and Welfare Benefit Programs, Labor-Management Services Administration, Department of Labor.

[FR Doc. 83-25555 Filed 9-22-83; 8:45 am]

BILLING CODE 4510-29-M

[Prohibited Transaction Exemption 85-58; Exemption Application No. D-4820 et al.]

Employee Benefit Plans; Grant of Individual Exemptions; Northwestern Ohio Building, et al.

AGENCY: Office Pension and Welfare Benefit Programs, Labor.

ACTION: Grant of individual exemptions.

SUMMARY: This document contains exemptions issued by the Department of Labor (the Department) from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

Notices were published in the Federal Register of the pendency before the Department of proposals to grant such exemptions. The notices set forth a summary of facts and representations contained in each application for exemption and referred interested persons to the respective applications for a complete statement of the facts and representations. The applications have been available for public inspection at the Department in Washington, D.C. The notices also invited interested persons to submit comments on the requested exemptions to the Department. In addition the notices stated that any interested person might submit a written request that a pubic hearing be held (where appropriate). The applicants have represented that they have complied with the requirements of the notification to interested persons. No public comments and no requests for a hearing, unless otherwise stated, were received by the Department.

The notices of pendency were issued and the exemptions are being granted solely by the Department because, effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type proposed to the Secretary of Labor.

Statutory Findings

In accordance with section 408(a) of the Act and/or section 4975(c)(2) of the Code and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975), and based upon the entire record, the Department makes the following findings:

(a) The exemptions are administratively feasible;

(b) They are in the interests of the plans and their participants and beneficiaries; and

(c) They are protective of the rights of the participants and beneficiaries of the plans.

Northwestern Ohio Building and Construction Trades and Employer Construction Industry Investment Plan (the Program), Located in Toledo, Ohio

[Prohibited Transaction Exemption 85-58; Exemption Application Nos. D-4680 and D-4681]

Exemption

The restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1) (A) through (D) of the Code, shall not apply to the proposed participation by employee benefit plans in construction loans through the Program where such loans are already committed to by certain lending institutions to parties in interest with respect to such plans, provided that the terms of the loans are not less favorable to the plans than those terms available in transactions with unrelated parties; and provided that the terms and conditions, as described in the notice of proposed exemption, are complied with during the operation of the Program.

For a more complete statement of the facts and representations supporting the Department's decision to grant this exemption refer to the notice of proposed exemption published on December 14, 1984 at 49 FR 48818.

For Further Information Contact: Mr. David Stander of the Department, telephone (202) 523-6881. (This is not a toll-free number.)

PAGE 11273

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the Code, including any prohibited transaction provisions to which the exemption doe not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) These exemptions are supplemental to and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fac that a transaction is subject to an administrative or statutory exemption not dispositive of whether the transaction is in fact a prohibited transaction.

(3) The availability of these exemptions is subject to the express condition that the material facts and representations contained in each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, D.C., this 14th day of March 1985.

Elliot I. Daniel,

Acting Assistant Administrator for Regulations and Interpretations, Office of Pension and Welfare Benefit Programs, U.S. Department of Labor.

[FR Doc. 85-6557 Filed 3-19-85; 8:45 am]

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D-4880 &
D-4881
1873

DEPARTMENT OF LABOR

Office of Pension and Welfare Benefit Programs

[Application No. D-4880 et al.]

Proposed Exemptions; Northwestern Ohio Building and Construction Trades, et al.

AGENCY: Pension and Welfare Benefit Programs, Labor.

ACTION: Notice of proposed exemptions.

SUMMARY: This document contains notices of pendency before the Department of Labor (the Department) of proposed exemptions from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

Written Comments and Hearing Requests

All interested persons are invited to submit written comments or requests for a hearing on the pending exemptions, unless otherwise stated in the Notice of Pendency, within 45 days from the date of publication of this Federal Register Notice. Comments and requests for a hearing should state the reasons for the writer's interest in the pending exemption.

ADDRESS: All written comments and requests for a hearing (at least three copies) should be sent to the Office of Fiduciary Standards, Pension and Welfare Benefit Programs, Room C-4526, U.S. Department of Labor, 200 Constitution Avenue, N.W., Washington, D.C. 20216. Attention: Application No. stated in each Notice of Pendency. The applications for exemption and the comments received will be available for public inspection in the Public Documents Room of Pension and Welfare Benefit Programs, U.S. Department of Labor, Room N-4677, 200 Constitution Avenue, N.W., Washington, D.C. 20216.

Notice to Interested Persons

Notice of the proposed exemptions will be provided to all interested persons in the manner agreed upon by the applicant and the Department within 15 days of the date of publication in the Federal Register. Such notice shall include a copy of the notice of pendency of the exemption as published in the Federal Register and shall inform interested persons of their right to comment and to request a hearing (where appropriate).

SUPPLEMENTARY INFORMATION: The proposed exemptions were requested in applications filed pursuant to section 408(a) of the Act and/or section 4975(c)(2) of the Code, and in accordance with procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). Effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type requested to the Secretary of Labor. Therefore, these notices of pendency are issued solely by the Department.

The applications contain representations with regard to the proposed exemptions which are summarized below. Interested persons are referred to the applications on file with the Department for a complete statement of the facts and representations.

Northwestern Ohio Building and Construction Trades and Employer Construction Industry Investment Plan (the Program) Located in Toledo, Ohio

[Application Nos. D-4880 and D-4881]

Proposed Exemption

The Department is considering granting an exemption under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). If the exemption is granted the restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the proposed participation by employee benefit plans in construction loans through the Program where such loans are already committed to by certain lending institutions to parties in interest with respect to such plans, provided that the terms of the loans are not less favorable to the plans than those terms available in transactions with unrelated parties; and provided that the terms and conditions, as described herein, are complied with during the operation of the Program.

Summary of Facts and Representations

1. The Northwestern Ohio Building and Construction Trades Council (the Council) is a confederation of local building and construction trade unions which represent building and construction tradesmen working in northwestern Ohio. The local unions are affiliates of members of the AFL-CIO Building Trades Department. The Northwestern Ohio Council of Construction Employers (the Employers) is a confederation of employers engaged in the building and construction industry in the same geographic area.

The Council and the Employers, on behalf of the local unions and employer's associations within their respective groups, desire to establish a construction industry investment program for the benefit of the employee pension benefit plans and welfare plans which they or their members co-sponsor. The plans are qualified under section 401 of the Code and comply with the requirements of the Labor Management Relations Act of 1947, particularly section 302 of such statute.

2. Under this program, the Council and the Employers will establish a foundation to be known as The Northwestern Ohio Building and Construction Trades Foundation (the Foundation). The Foundation will be a non-profit unincorporated association organized under and governed by the laws of Ohio. The Foundation will provide that any employee benefit plan qualified under section 401 of the Code, and co-sponsored by the Council or any local union affiliated with it or the Employers may elect to participate in the Foundation. The Foundation will be administered by a Board of Trustees (the Trustees). Every plan participating in the Foundation will be entitled to two Trustees on the Foundation's Board, one appointed by the union co-sponsor of the plan and the other by the employer association co-sponsor of the plan. The Trustees will be required and directed by the Foundation agreement to establish and administer the Program.

3. Pursuant to the terms of the Foundation documents, the Trustees will

contact every bank, savings and loan association and insurance company (as defined in Part B of Prohibited Transaction Exemption 76-1 (PTE 76-1, 41 FR 12740, pg. 12743, March 6, 1976) in the jurisdiction covered by the plans participating in the Program (the Northwestern Ohio quadrant), and request such institutions to allow the plans to participate in construction loans of $400,000 or more in which such lending institutions have made a legally enforceable commitment.[1] The applicants represent that it is not feasible to include small construction loans for homes, remodeling or minor additions, i.e. $25,000, $50,000, in the Program. The applicant represents that more than 80% of the construction loans originated will be at or above the $400,000 threshold. All institutions agreeing to participate in the Program will agree to notify the Trustees (or Administrative Manager) of the Program of all applications for construction loans which have been approved by the institution and agreed to be submitted by the borrower, and supply the Trustees with any requested data and information concerning the loans. The applicant represents that all lending institutions will affirmatively recommend that borrowers consent to the submission of the loan documents to the Program. In this regard the applicant represents that the borrower refusal rate will constitute 10% to 15% of all transactions. The Trustees of the Program will notify the trustees or other designated representatives of every participating plan of all information received by them. The fiduciaries of the participating plans will then determine whether they intend to participate in a specific construction loan and if so, the amount of their participation.

The Trustees of the Program will accumulate the responses from all of the participating plans and will then advise the lending institution of its desire to participate in a loan, and, if so, the amount of the participation. The amount of the participation will be the amount of the aggregate participations made by the individual employee benefit plans. Each said loan will be deemed and construed to constitute a separate and distinct legal transaction and will be documented as a separate trust. The Trustees will maintain their books and records of account accordingly.

4. Each participating plan will then, within a certain period following its decision to participate in the loan, forward the amount of its participation to the lending institution. The lending institution will keep all such advances invested in certain designated short-term instruments until the lending institution funds the construction loan. The earnings on such advances will be a part of the plan's funding of the loan, and any excess amounts will be remitted by the institution to the participating plans.

5. The Trustees of the Program will keep proper books and records to account for all advances made by participating plans. All returns of principal and/or interest received by the lending institution from a construction mortgage loan in which a plan participates will be returned to the trustees of the participating plan(s) within five days after receipt. Periodically, the Trustees of the Program will report to the trustees of the participating plans and to the affiliated local unions and management associations on their operations. No Trustee will receive any compensation for his services to the Foundation or the Plan. The Trustees may incur reasonable expenses for necessary professional services to implement and operate the Program, and may obtain from the lead mortgage lenders and/or the participating plans reimbursement for reasonable expenses actually incurred. No part of the principal or income of any investment will be received or retained by the Foundation or its Trustees.

6. Because some construction loans may be made to parties in interest with respect to participating plans, such as contributing employers, the applicant seeks an exemption from section 4JG(a) of the Act for the transactions. The applicant represents that because the Program documents will provide that independent plan trustees or other fiduciaries will have sole and exclusive authority with regard to a plan's decision to participate in a loan, no relief from section 406(b) of the Act for Program transactions is requested.[2]

7. The applicant represents that lending institutions will have made a formal and legally binding commitment to make the construction loan before the opportunity for participation by employee benefit plans is distributed through the Program. The applicants represent that the Foundation will receive from all cooperating lending institutions all qualified loan commitments for consideration, and will not participate in a loan unless it is at or above the prevailing market rate of interest and value for comparable loans. In no event will participating plans either individually or in the aggregate acquire more than a 50% participation in any one loan.

8. The applicant represents that participating plans will invest ab initio together with a lending institution and will not be purchasing participation interests from such lending institution. As well, the applicant represents that participating plans will receive their pro rata share of the points charged by the lending institution to the extent such points represent a return on the loan and not compensation and/or reimbursement to the lending institution for actual expenses incurred and/or services rendered in servicing the construction mortgage loan. The plans pro rata share will be the ratio of the amount of the plan's funding participation to the total amount of the loan. To the extent such above transactions, or any other transactions between the plans and the lending institutions, constitute violtions of section 406 of the Act, the Department is not proposing relief for such transactions.

9. The applicant represents that in the event of a default by a borrower the lead lender, i.e. a lending institution, will have responsibility to enforce the rights of all of the lenders, including participation interest holders, under the loan. The applicant further represents that all of the loans subject to the Program will remain in the portfolio of the lead lender financial institution and thus not be transferred to other lenders.

10. The applicant represents that before a plan participates in a construction loan, the Foundation and each participating plan will receive from the lead lender a written commitment for permanent financing from a person other than the participating plan or another plan which is part of the Program to enable full repayment of the loan upon completion of construction. In

[1] Pt B of PTE 76-1 provides, in general, exemptive relief from section 406(a) of the Act for construction loans made by a multiple employer plan to a participating employer if, inter alia, the decision to make the loan is made on behalf of the plan by a bank, savings and loan association or insurance company as described in that exemption.

[2] In this exemption the Department expresses no opinion as to whether transactions involving construction loans to parties in interest will involve transactions as described in section 406(b) of the Act. As well, the Department is not expressing an opinion as to whether the structure, maintenance, and operation of the Program, including the participation with the lending institutions in construction loans to non-parties in interest, will violate provisions of Part 4 of Title I of the Act. The Department notes, as stated in the preamble to Part B of PTE 76-1, 41 FR 12743, that a loan made to a non-party in interest may give rise to a prohibited transaction if, for example, the loan is made in the context of an arrangement for a specific participating employer to furnish a portion of the construction, and such employer has a controlling influence over the plan's decision to make the loan.

addition, the Foundation will not accept loan participations by any plan which would, as to any individual loan participation, exceed 10% of the assets of the plan, or in the aggregate with all other construction loan participations, exceed 25% of the assets of the plan. Further, the Foundation and each participating plan will maintain or cause to be maintained for a period of six years from the date of each loan participation such records as are necessary to enable the Department, the Internal Revenue Service, the plan's participants and beneficiaries, any employer of plan participants and beneficiaries, or any employee organization whose members are covered by the plan to determine whether all conditions of the exemption have been met.[6]

[6]The Department notes the applicant's October 27, 1983, representation to the Securities and Exchange Commission whereby the applicant states that the Foundation will allow participating plans to "focus a portion of their funds on investments that would benefit both their members and the local community. Rather than investing in anonymous corporations or other more traditional investment media the plans hope to encourage new construction within their jurisdictions and create jobs for their members. By creating an umbrella organization such as the Foundation, the plans can contribute to the financing of a larger number of projects, and involve themselves in more extensive projects." The Department notes that to the extent the fiduciaries of the participating plans restrict their considerations of investment opportunities for non-economic reasons, such conduct may involve certain violations of Part 4 of Title I of the Act which violations if present would not be provided relief by this exemption.

In this regard, section 404(a)(1) of the Act requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. To act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan. Because construction loans are investments which would be selected, if at all, in preference to alternative investments, a loan would not be prudent if it provided a plan with less return, in comparison to risk, than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.

The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in construction loans, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make a loan may not be influenced by a desire to stimulate the housing industry and preserve employment, unless the loan, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan. (See Advisory Opinion 81-12A, January 13, 1981.)

11. In summary, the applicant represents that the proposed transactions satisfy the statutory criteria of section 408(a) of the Act because (a) independent plan trustees and fiduciaries will have sole and exclusive authority to cause a plan to participate in a loan; (b) the lending institutions will have made a legally enforceable commitment to make a construction loan before plans consider participation in the loan; and (c) no more than 10% of the assets of any participating plan may be invested in any individual loan participation and no more than 25% of a plan's assets may be invested in construction loans in the aggregate.

Notice to Interested Persons: Notice to interested persons will be provided within 30 days of the date of publication of this notice in the **Federal Register**. Notice will include a copy of this notice as published in the **Federal Register** and a statement informing interested persons of their right to comment. Comments to the Department are due within 60 days of the date of publication of this notice.

For Further Information Contact: Mr. David Stander of the Department, telephone (202) 523-8881. (This is not a toll-free number.)

PAGE 48832

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) Before an exemption may be granted under section 408(a) of the Act and/or section 4975(c)(2) of the Code, the Department must find that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries of the plan; and

(3) The proposed exemptions, if granted, will be supplemental to, and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(4) The proposed exemptions, if granted, will be subject to the express condition that the material facts and representations contained in each application are true and complete, and that each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, D.C., this 10th day of December, 1984.

Elliot L. Daniel,

Acting Assistant Administrator for Regulations and Interpretations, Office of Pension and Welfare Benefit Programs, Department of Labor.

[FR Doc. 84-32670 Filed 12-13-84; 8:45 am]

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D-4880 &
D-4881
3 of 3

Racine Construction Industry Pension Fund (the Plan) Located in Racine, Wisconsin

[Prohibited Transaction Exemption 87-20; Exemption Application No. D-6800]

Exemption

The restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1) (A) through (D) of the Code, shall not apply to the provision of long term mortgage financing by the Plan to property owners where such financing is to be used to retire construction loans extended by banks which are nonfiduciary parties in interest with respect to the Plan, provided that:

A. Such mortgage loan is expressly approved by a fiduciary independent of the construction lender who has authority to manage or control those Plan assets being invested;

B. The terms of each such transaction is not less favorable to the Plan than the terms generally available in an arm's-length transaction between unrelated parties; and

(C) No investment management, advisory, underwriting or sales commission or similar compensation is paid to the construction lender with regard to such transaction.

For a more complete statement of the facts and representations supporting the Department's decision to grant this exemption refer to the notice of proposed exemption published on November 18, 1986 at 51 FR 41708.

For Further Information Contact: Alan H. Levitas of the Department, telephone (202) 523-8194. (This is not a toll-free number.)

A. Such mortgage loan is expressly approved by a fiduciary independent of the construction lender who has authority to manage or control those Plan assets being invested;

B. The terms of each such transaction is not less favorable to the Plan than the terms generally available in an arm's-length transaction between unrelated parties; and

(C) No investment management, advisory, underwriting or sales commission or similar compensation is paid to the construction lender with regard to such transaction.

Summary of Facts and Representations

1. The Plan is a multiemployer pension plan which had approximately 956 participants and net assets of approximately $13,322,115 as of December 31, 1985. The board of trustees of the Plan is comprised of three employer-appointed trustees and three union-appointed trustees (collectively, the Trustees), with the employer and union trustees entitled to cast an equal number of aggregate votes. Investment decisions for the Plan are made by the Trustees.

2. The Plan proposes to engage in long-term mortgage financing for certain commercial construction projects. The Plan does not propose to engage in so-called interim or construction financing. Construction of such commercial properties may be performed by persons who are parties in interest or disqualified persons with respect to the Plan.[11] Specifically, however, the transaction for which exemptive relief is sought is the payoff by the Plan of the short term construction lender with proceeds from the long-term mortgage loan, where the short-term construction lender is a party in interest with respect to the Plan by reason of servicing the Plan's mortgages. In no case, however, will the short term lender be a fiduciary with respect to the Plan.

3. Long-term mortgage financing transactions involving the Plan typically begin when a prospective borrower approaches a mortgage banker [12] to discuss financing. The mortgage banker makes an initial determination as to the feasibility of the proposed project. If that determination is favorable, the prospective borrower enters into an agreement authorizing the mortgage banker to act as his agent in attempting to obtain long-term financing. Typically, this agreement provides that the mortgage banker will receive a one point "origination fee" (an amount equal to 1% of the local loan) [13] from the borrower for obtaining a long-term financing commitment. Up to this point, the Plan has had no involvement in the transaction. Also to this point, the prospective borrower typically would not have obtained short-term construction financing.

In the next phase, the mortgage banker prepares a loan offering for submission to potential lenders. If the mortgage banker believes the project meets the Plan's long-term lending criteria, he presents a copy of the loan offering for consideration by the Trustee. All loan offerings must be prepared in accordance with the Trustee's criteria and must offer a return equal to the current rate for similar financing. Satisfaction of the published criteria does not, however, result in automatic approval. Financing applications are individually considered and acted upon by the Trustee after it is determined that they satisfy the published criteria. Upon review of the loan offering, the Trustee may accept the proposal or offer a counter-proposal on terms different from those originally proposed. If the proposal is accepted, or if the borrower accepts a counter-proposal, the Plan would issue a commitment to provide long-term financing.

4. The Plan's mortgage application form states, among other things, that all construction, except that which is not within the jurisdiction of a union participating in the Plan, must be performed by contractors and subcontractors contributing to and who are in good standing with the Plan and who employ 100 percent AFL-CIO union construction labor. Construction, including all landscaping, must be 100 percent completed by such labor. The borrower must furnish a list to the Plan showing the names of the general contractor and subcontractors and any addition or substitution to that list must be submitted for review by the Plan before such addition or substitution could be made.[14]

Racine Construction Industry Pension Fund (the Plan) Located in Racine, Wisconsin

[Application No. D-5890]

Proposed Exemption

The Department is considering granting an exemption under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 25, 1975). If the exemption is granted the restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the provision of long term mortgage financing by the Plan to property owners where such financing is to be used to retire construction loans extended by banks which are non-fiduciary parties in interest with respect to the Plan, provided that:

[11] The Department notes that where the construction on the property which secures a mortgage loan made by the Plan was by a contributing employer, and a principal of such employer exercises fiduciary authority in approving the Plan's investment in the mortgage, a prohibited transaction may occur, which transaction would not be covered by this exemption.

[12] The Plan makes financing commitments only in Racine County.

[13] The origination fee charged on any given situation depends on the then existing "market" conditions.

[14] With respect to the geographic and union labo criteria, it should be noted that section 404(a)(1) of Act requires, among other things, that a fiduciary c a plan act prudently, solely in the interest of the plan's participants and beneficiaries and for the

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5. The applicant represents that the total unpaid balance of the Plan's mortgage portfolio shall not, at any time, exceed 25 percent of the Plan's total assets. In addition, the total unpaid balance of any one mortgage which has been committed to and closed by the Plan shall not exceed 10 percent of the Plan's total assets. Mortgage financing applications will only be accepted from individuals who are not parties in interest with respect to the Plan. In some instances, financing applications may be received and considered prior to the selection of general contractors or subcontractors for the project involved. The Trustee considers financing applications without regard to the identity of the general contractor and/or the subcontractors who may potentially be selected (or who may already have been selected if such selection was made prior to submission of the financing application). The Trustee's decisions on the issuance of mortgage commitments are final.

6. The borrower normally obtains construction financing through the mortgage banker. When the borrower obtains the short-term construction loan a tri-party agreement may be entered between the Plan, borrower and mortgage banker. The tri-party agreement confirms the parties' understanding that upon completion of the project in accordance with Plan requirements, the Plan will provide the approved loan amount in order to substitute its financing for the short-term funds. The agreement provides for simultaneous assignment of the short-term lender's first mortgage lien to the Plan. This agreement is not required by all mortgage bankers, and, in the absence of an agreement, substitution of the Plan's long-term loan for short-term financing follows the same assignment procedure. The mortgage banker then secures note and mortgage instruments (which documents are prepared with a view to their furture assignment) from the borrower and the borrower begins construction.

Throughout construction, the mortgage banker monitors the project and its progress, making the necessary construction inspections and paying out short-term funds as the work progresses. Upon completion of the project, the mortgage banker makes the necessary inspections and final payouts and a loan closing is scheduled between the borrower and the Plan.

7. Upon completion of the project, the Plan's commitment remains contingent until satisfaction of certain conditions. The conditions include: (i) Issuance of an appraisal by a member of the American Institute of Appraisers showing that the Plan loan will not exceed 75 percent of the project's appraised value.[18] (ii) issuance of a title policy insuring the first lien status of the Plan's mortgage interest in an amount at least equal to the amount of the loan, (iii) receipt of an architect's certificate that construction conforms to the plans and specifications and meets applicable zoning and ordinance restrictions, (iv) issuance of a certification from the appropriate municipal building inspector that the project is complete and ready for occupancy, and (v) presentation of a hazard insurance policy in an amount at least equal to the Plan's loan and naming the Plan payee. If all those conditions are met, the Plan transfers its committed loan funds in exchange for an assignment of the note and mortgages. Typically, the borrower would sign a direction to pay, authorizing the Plan to make the loan to the borrower by paying the loan amount to the mortgage banker. Other documentation (such as title insurance policies, certifications and appraisals) are also reviewed and transferred at this time.

8. As part of the loan offering, the mortgage banker may agree to service the long-term loan on behalf of the Plan. This servicing includes receipt and handling of scheduled payments, preparation and maintenance of accounts (showing allocation of payments between principal and interest), periodic inspections of the property, and demands for proof of continuing hazard insurance coverage. As compensation for such service, the mortgage banker typically receives from the Plan an amount equal to one-eighth of one percent per annum, of the unpaid amount of the loan.[19]

9. In summary, the applicant represent that the statutory criteria contained in section 408(a) of the Act have been satisfied because:

(a) The Plan has vigorous standards for the approval of any mortgage loan;

(b) The Trustee will review and approve all application for financing;

(c) No more than 25% of the Plan's assets will be invested in mortgage loans; and

(d) No mortgage loans will be made to parties in interest.

For Further Information Contact: Mr. Alan H. Levitas of the Department, telephone (202) 523-8194. (This is not a toll-free number.)

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exclusive purpose of providing benefits to participants and beneficiaries when making investment decisions on behalf of a plan. In order to act prudently in making investment decisions, the trustees must consider, among other factors, the availability, risks, and potential return of alternative investments for the plan. Investing plan assets in loans meeting these criteria would not satisfy section 404(a)(1) if such loans would provide the plan with less return, in comparison to risk, than comparable investments available to the plan or if such loans would involve a greater risk to the security of plan assets than other investments offering a similar return.

Thus, in deciding whether and to what extent to invest in mortgage loans, the trustees must consider only factors relating to the interests of plan participants and beneficiaries in their retirement incomes. A decision to make a loan may not be influenced by a desire to stimulate business in a particular geographic area or to encourage the use of union labor unless the investment, when judged solely on the basis of its economic value, would be equal to or superior to alternative investments available to the plan.

[18] In this connection, it should be noted that while the Plan may agree to lend up to 75 percent of appraised value, the loan will not, in any event, exceed actual borrower disbursements. Thus, the Plan loan will reimburse for costs but will not provide any additional funds that the borrower might otherwise use for his own account prior to repayment.

[19] The compensation paid for mortgage servicing with respect to a given mortgage depends on the then existing "market" conditions.

D-6890
20,972

Dayton Area Building and Construction Industry Investment Plan (the Program) Located in Dayton, Ohio

(Prohibited Transaction Exemption 87-70; Exemption Application Nos. D-7003 and D-7004)

Exemption

The restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1) (A) through (D) of the Code, shall not apply to the proposed participation by employee benefit plans in construction loans through the Program where such loans are already committed to by certain lending institutions to parties in interest with respect to such plans, provided that the terms of the loans are not less favorable to the plans than those terms available in transactions with unrelated parties; and provided that the terms and conditions, as described in the notice of proposed exemption, are complied with during the operation of the Program.

For a more complete statement of the facts and representations supporting the Department's decision to grant this exemption refer to the notice of proposed exemption published on April 10, 1987 at 52 FR 11783.

FOR FURTHER INFORMATION CONTACT: Mrs. Betsy Scott of the Department, telephone (202) 523-8196. (This is not a toll-free number.)

87-70
D-7003 &
D-7004

Dayton Area Building and Construction Industry Investment Plan (the Program), Located in Dayton, OH

[Application Nos. D-7003 and D-7004]

Proposed Exemption

The Department is considering granting an exemption under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). If the exemption is

PAGE 11784

granted the restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1) (A) through (D) of the Code shall not apply to the proposed participation by employee benefit plans in construction loans through the Program where such loans are already committed to by certain lending institutions to parties in interest with respect to such plans, provided that the terms of the loans are not less favorable to the plans than those terms available in transactions with unrelated parties; and provided that the terms and conditions, as described herein are complied with during the operation of the Program.

Summary of Facts and Representations

1. Employer benefit plans (the Plans)[1] co-sponsored by local building and construction industry unions[2] affiliated with the Dayton Building Trades Council and local associations affiliated with the West Central Ohio Division of the Associated General Contractors Association and/or other employer associations representing building and construction industry employers in the Dayton area are in the process of establishing the Dayton Area Building and Construction Industry Foundation (the Foundation). The following Plans will be part of the Foundation and participate in the Program: Miami Valley Carpenters District Council Pension Plan and Trust; International Brotherhood of Electrical Workers Local No. 82 Joint Pension Plan and Trust; Bricklayers and Masons Local No. 22 Pension Plan and Trust; Iron Workers District Council of Southern Ohio and Vicinity Pension Plan and Trust; Ohio State Roofers and Waterproofers District Council Pension Plan and Trust; Plumbers and Pipefitters Local No. 162 Pension Plan and Trust; and Sheet Metal Workers' Local Union No. 224 Pension Plan and Trust. The jurisdiction covered by the Plans is the Dayton, Ohio area.

[1] All of the local unions are local affiliates of international unions affiliated with the AFL-CIO Building and Construction Trades Council.

The Foundation will provide a procedure and system whereby member plans may invest in construction mortgage loans. The Foundation is to be administered by a Board of Trustees (the Trustees). Every employee benefit plan participating in the Foundation will name two trustees to serve on its Board, one union trustee and one management trustee. The Trustees are required and directed by the Foundation Agreement to establish and administer the Program.

2. The Trustees are developing a package of documents for the operation and administration of the Program. The Trustees are also contacting every bank, savings and loan association and insurance company, as defined in Part B of Prohibited Transaction Exemption 75-1 (PTE 75-1, 41 FR 12740, pg. 12743, March 6, 1976), in the jurisdiction covered by the Foundation, and requesting that such entities allow the Foundation to participate in all construction mortgage loans of $200,000 or more in which such lending institutions have made a legally enforceable commitment.[3]

All institutions agreeing to participate with the Foundation will agree to: (a) Notify the Trustees (or Administrative Manager) of the Foundation of all applications for construction mortgage loans which have been approved by the institution and commenced to be submitted by the borrower; and (b) supply the Trustees with any requested data and information concerning the loans. The applicants represent that all lending institutions will affirmatively recommend that borrowers consent to the submission of the loan documents to the Program. In this regard, the applicants represent that the borrower refusal rate will constitute 12% to 20% of all transactions. Upon receipt of this information from the institutions, the Foundation will notify the trustees or other designated representatives of every participating Plan of all information received by them. The trustees of the participating Plans will then determine whether they intend to participate in a specific construction loan and, if so, the amount of their participation.

3. The Foundation will accumulate the responses from all of the participating Plans and will then advise the lending institutions of the Foundation's desire to participate in a loan and, if so, the amount of the participation. The amount of the participation will be the amount of the aggregate participations by the individual Plans. Each said loan will be deemed and construed to constitute a separate and distinct legal transaction and will be documented as a separate trust. The Foundation will maintain its books and records of accounts accordingly.

4. Each participating Plan will, within 30 days of its determination and notification of its intention to participate in a specific construction mortgage loan, forward the amount of its participation to the lead lending institution. The lead lending institution will keep all such advances productively invested until advances are required to be made to the borrower. The earnings on such advances will be a part of the advance and any excess will be remitted by the institution to the participating Plans.

5. The Foundation will keep proper books and records to account for all advances from participating Plans and all returns of principal and/or income from the lending institution making the loan. All returns of principal and/or interest by the lending institution for participation in any construction mortgage loan will be returned to the trustees of the participating Plan(s) within five days after receipt. Periodically, the Foundation will report to the trustees of the participating Plans and to the affiliated local unions and management associations on its operations. No Foundation Trustee will receive any compensation for his services to the Foundation or the Program. The Foundation may incur reasonable expenses for necessary professional services to implement and operate the Program and may obtain from the lead mortgage lenders and/or the participating Plans reimbursement for reasonable expenses actually incurred. No part of the principal or income of any investment will be received or retained by the Foundation or its Trustees.

6. Because some construction loans may be made to parties in interest with respect to the participating Plans, such as contributing employers, the applicants seek an exemption from section 406(a) of the Act for the transactions. The applicants represent that the Program documents will provide that a trustee of any Plan which has an interest in the employer entity involved in a construction project to be financed by a commitment must: (a) Abstain himself from voting on a participation determination; (b) absent himself from that portion of the Plan trustees' meeting when the issue of the purchase of such participation is under discussion and consideration; and (c) represent on the record that he has not attempted to exert any influence on any trustee regarding the participation. The

[3] Part B of PTE 75-1 provides, in general, exemptive relief from section 406(a) of the Act for conservation loans made by multiple employer plans to a participating employer of, inter alia, the decision to make the loans is made on behalf of the plan by a bank, savings and loan association or insurance company as described in that exemption.

D-7003 & D-7004 1 of 2

applicants further represent that, because of such Program document language, no relief from section 406(b) of the Act for Program transactions is requested.[9]

PAGE 11785

7. The applicants represent that lending institutions will have made a formal and legally binding commitment to make the construction mortgage loan before the opportunity for participation by the Plans is distributed through the Program. The applicants represent that the Foundation will receive from all cooperating lending institutions all qualified loan commitments for consideration whether or not such commitments are for local or non-local developers or construction projects or union-built or non-union built construction projects. The applicants further represent that the Foundation will not participate in a loan unless it is at or above the prevailing market rate of interest and value for comparable loans.[10] In no event will participating plans either individually or in the aggregate acquire more than a 50% participation in any one loan.

8. The applicants represent that participating plans will invest *ab initio* together with a lending institution and will not be purchasing participation interest from such lending institution. As well, the applicants represent that the participating Plans will receive their pro rata share of the points charged by the lending institution to the extent such points represent a return on the loan and not compensation and/or reimbursement to the lending institution for actual expenses incurred and/or services rendered in servicing the construction mortgage loan. A Plan's pro rata share will be the ratio of the amount of the Plan's funding participation to the total amount of the loan. To the extent the above transactions, or any other transactions between the Plans and the lending institutions, constitute violations of section 406 of the Act, the Department is not proposing relief for such transactions.

9. The applicants represent that, in the event of a default by a borrower, the lead lending institution will have responsibility to enforce the rights of all of the lenders, including participating interest holders, under the loan. The applicants further represent that all of the loans subject to the Program will remain in the portfolio of the lead lending institution and thus not be transferred to other lenders.

10. The applicants represent that before a loan is made, the Foundation will receive from the lead lender a written commitment for permanent financing from a person other than a Plan which is a member of the Foundation to enable full repayment of the loan upon completion of construction. In addition, the Foundation will not accept loan participations by any Plan which would, as to any individual loan participation, exceed 10% of the assets of the Plan, or in the aggregate with all other construction loan participations, exceed 25% of the assets of the Plan. Further, the Foundation will maintain or cause to be maintained for a period of six years from the date of each loan participation such records as are necessary to enable the Department, the Internal Revenue Service, the Plan's participants and beneficiaries, any employer of plan participants and beneficiaries, or any employee organization whose members are covered by the Plans to determine whether all conditions of the exemption have.

11. In summary, the applicants represent that the proposed transactions satisfy the statutory criteria of section 408(a) of the Act because: (a) Trustees o each participating Plan will have sole and exclusive authority to cause the Plan to participate in a loan; (b) the lending institutions will have made a legally enforceable commitment to make a construction loan before the Plans consider participation in a loan; and (c) no more than 10% of the assets of any participating plan may be invested in any individual loan participation and no more than 25% of a plan's assets may be invested in construction loans in the aggregate.

Notice to Interested Persons: Notice to interested persons will be provided within 30 days of the date of publication of this notice in the Federal Register. Notice will include a copy of this notice as published in the Federal Register and a statement informing interested persons of their right to comment. Comments to the Department are due within 60 days of the date of publication of this notice.

For further information contact: Betsy Scott of the Department, telephone (202) 523-8196. (This is not a toll-free number.)

D-7003 &
D-7004

2072

[9] In this exemption, the Department expresses no opinion as to whether transactions involving construction loans to parties in interest will involve transactions as described in section 406(b) of the Act. As well, the Department is not expressing an opinion as to whether the structure, maintenance, and operation of the Program, including the participation with the lending institutions in construction loans to non-parties in interest, will violate provisions of Part 4 of Title I of the Act. The Department notes, as stated in the preamble to Part 8 of PTE 79-1, 44 FR 12743, that a loan made to a non-party in interest may give rise to a prohibited transaction if, for example, the loan is made to the extent of an arrangement for a specific participating employer to furnish a portion of the construction and such employer has a controlling influence over the plan's decision to make the loan.

[10] The Department notes that to the extent the fiduciaries of the participating Plans restrict their consideration of investment opportunities for non-economic reasons, such conduct may involve certain violations of Part 4 of Title I of the Act which violations, if present, would not be provided relief by this exemption.

In this regard, section 404(a)(1) of the Act requires among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. To act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan. Because construction loans are investments which would be selected, if at all, in preference to alternative investments, a loan would not be prudent if it provided a plan with less return in comparison to risk than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.

The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in construction loans, a fiduciary must ordinarily consider only factors relating to the interest of plan participants and beneficiaries in their retirement income. For example, a decision to make a loan may not be influenced by a desire to stimulate the construction industry and generate employment, unless the loan, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan. (See Advisory Opinion 81-12A, January 12, 1981).

[Prohibited Transaction Exemption 88-95; Exemption Application No. D-6837 et al.]

Grant of Individual Exemptions; Real Estate for American Labor A Balcor Group Trust, et al.

AGENCY: Pension and Welfare Benefits Administration, Labor.

ACTION: Grant of individual exemptions.

SUMMARY: This document contains exemptions issued by the Department of Labor (the Department) from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

Notices were published in the Federal Register of the pendency before the Department of proposals to grant such exemptions. The notices set forth a summary of facts and representations contained in each application for exemption and referred interested persons to the respective applications for a complete statement of the facts and representations. The applications have been available for public inspection at the Department in Washington, DC. The notices also invited interested persons to submit comments on the requested exemptions to the Department. In addition the notices stated that any interested person might submit a written request that a public hearing be held (where appropriate). The applicants have represented that they have complied with the requirements of the notification to interested persons. No public comments and no requests for a hearing, unless otherwise stated, were received by the Department.

The notices of pendency were issued and the exemptions are being granted solely by the Department because, effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type proposed to the Secretary of Labor.

Statutory Findings

In accordance with section 408(a) of the Act and/or section 4975(c)(2) of the Code and the procedures set forth in ERISA Procedure 75-1 (43 FR 18471, April 29, 1975), and based upon the entire record, the Department makes the following findings:

(a) The exemptions are administratively feasible;

(b) They are in the interests of the plans and their participants and beneficiaries; and

D-6837

PAGE 43293

(c) They are protective of the rights of the participants and beneficiaries of the plans.

Real Estate for American Labor A Balcor Group Trust (the Trust), Located in Chicago, IL

[Prohibited Transaction 88-96; Exemption Application No. D-6837]

Exemption

Section I. Exemption for Certain Transactions Involving the Trust

(a) The restrictions of sections 406(a), 406(b)(2) and 407(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code, shall not apply to the transactions described below if the applicable conditions set forth in Section IV are met.

(1) *Transactions Between Parties-In-Interest and the Trust: General.* Any transaction between a party-in-interest with respect to a plan which has an interest in the Trust (a Participating Plan) and the Trust, or any acquisition or holding by the Trust of employer securities or employer real property, if the party in interest is not Balcor Institutional Realty Advisors, Inc. (Balcor) or one of its affiliates, any other trust maintained by Balcor or one of its affiliates, and if, at the time of the transaction, acquisition or holding, the interest of the Participating Plan, together with the interest of any other Participating Plan maintained by the same employer or employee organization in the Trust, does not exceed 10 percent of the total of all assets in the Trust.

(2) *Special Transactions Not Meeting the Criteria of Section I(c)(1) Between Employers of Employees Covered by a Multiemployer Plan and the Trust.* Any transaction between an employer (or an affiliate of an employer) of employees covered by a multiemployer plan (as defined in section 3(37)(A) of the Act and section 414(f)(1) of the Code) that is a Participating Plan, and the Trust, or any acquisition or holding by the Trust of employer securities or employer real property, if at the time of the transaction, acquisition or holding—

The interest of the multiemployer plan in the Trust exceeds 10 percent of the total assets in the Trust, but the employer is not a "substantial employer" with respect to the plan and would not be a "substantial employer" if "5 percent" were substituted for "10 percent" in the definition of "substantial employer."

(3) *Acquisitions, Sales, or Holdings of Employer Securities and Employer Real Property.* (A) Except as provided in subsection (B) of this section (3), any acquisition, sale or holding of employer securities or employer real property by the Trust which does not meet the requirement of paragraphs (a)(1) and (a)(2) of this Section I, if no commission is paid to Balcor or to the employer, or any affiliate of Balcor or the employer in connection with the acquisition or sale of employer securities or the acquisition, sale or lease of employer real property; and

(i) In the case of employer real property—

(aa) Each parcel of employer real property and the improvements thereon held by the Trust are suitable (or adaptable without excessive cost) for use by different tenants, and

(bb) The property of the Trust that is leased or held for lease to others, in the aggregate, is diversified geographically.

(ii) In the case of employer securities—

(aa) Neither Balcor nor any of its affiliates is an affiliate of the issuer of the security, and

(bb) If the security is an obligation of the issuer, either:

1. The Trust owns the obligation at the time the plan acquires an interest in the Trust, and interests in the Trust are offered and redeemed in accordance with valuation procedures of the section applied on a uniform or consistent basis, or

2. Immediately after acquisition of the obligation by the Trust not more than 25 percent of the aggregate amount of obligations issued in the issue and outstanding at the time of acquisition is held by such plan, and at least 50 percent of the aggregate amount of obligations issued in the issue and outstanding at the time of acquisition is held by persons independent of the issuer. Balcor, its affiliates, and any collective investment fund maintained by Balcor or its affiliates, shall be considered to be persons independent of the issuer if Balcor is not an affiliate of the issuer.

(B) In the case of a Participating Plan that is not an eligible individual account plan (as defined in section 407(d)(3) of the Act), the exemption provided in subsection (A) of this section (3) shall be available only if, immediately after the acquisition of the securities or real property, the aggregate fair market value of employer securities and employer real property with respect to which Balcor or its affiliate has investment discretion does not exceed 10 percent of the fair market value of all the assets of the Participating Plan with respect to which Balcor or its affiliate has such investment discretion.

PAGE 43294

(C) For purposes of the exemption contained in subsection (A) of this section (3), the term "employer securities" shall include securities issued by, and the term "employer real property" shall include real property leased to, a person who is a party-in-interest with respect to a Participating Plan by reason of a relationship to the employer described in section 3(14) (E), (G), (H) or (I) of the Act.

(b) The restrictions of section 406(a)(1)(A) through (D) and section 406(b)(1) and (b)(2) of the Act and the sanctions resulting from the application of section 4975 of the Code by reason of section 4975(c)(1)(A) through (E) of the Code shall not apply to the transactions described below, if the conditions of Section IV are met.

(1) *Certain Leases and Goods.* The furnishing of goods to the Trust by a party-in-interest with respect to a Participating Plan or the leasing of real property owned by the Trust to such party-in-interest and the incidental furnishing of goods to such party-in-interest by the Trust, if—

(A) In the case of goods, they are furnished to or by the Trust in connection with real property owned by the Trust;

(B) The party-in-interest is not Balcor, any affiliate of Balcor, or one of the other trusts; and

(C) The amount involved in the furnishing of goods or leasing of real property in any calendar year (including the amount under any other lease or arrangement for the furnishing of goods in connection with the real property investments of the Trust with the same party-in-interest, or any affiliate thereof) does not exceed the greater of $25,000 or 0.5 percent of the fair market value of the assets of the Trust on the most recent valuation date of the Trust prior to the transaction.

(2) *Transactions Involving Places of Public Accommodation.* The furnishing of services, facilities and any goods incidental to such services and facilities by a place of public accommodation owned by the Trust to a party-in-interest with respect to a Participating Plan, if the services, facilities and incidental goods are furnished on a comparable basis to the general public.

(c) The restrictions of section 406(a)(1)(A) through (D) of the Act and the sanctions resulting from the application of section 4975 of the Code by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the following transactions if the conditions of Section IV are met:

D-6837, ALJ 3

Any transaction between the Trust and a person who is a party in interest with respect to a Participating Plan, if—

(1) The person is a party in interest (including a fiduciary) solely by reason of providing services to the Participating Plan, or solely by reason of a relationship to a service provider described in section 3(14) (F), (G), (H) or (I) of the Act, or both, and the person neither exercised nor has any discretionary authority, control, responsibility or influence with respect to the investment of the Participating Plan's assets in, or held by, the Trust;

(2) At the time of the transaction, the interest of the Participating Plan, together with the interests of any other Participating Plan maintained by the same employer or employee organization in the Trust, does not exceed 20 percent of the total of all assets in the Trust; and

(3) The person is not Balcor or an affiliate of Balcor.

(d) The restrictions of section 406(a)(1)(A) through (D) of the Act and the sanctions resulting from the application of section 4975 of the Code by reasons of section 4975(c)(1) (A) through (D) of the Code shall not apply to the purchase and sale of units of beneficial interest (Units) in the Trust if no more than reasonable compensation is paid therefor and (a) each purchase and sale is authorized in writing by a fiduciary of the Participating Plan who is independent of Balcor and any of its affiliates or (b) the purchase or sale is a mandatory redemption required by the Trust Agreement, including the failure of the Participating Plan to remain a plan which can invest in a group trust described in section 401(a)(24) of the Code, and the applicable conditions of Section IV are met.

Section II. Excess Holdings Exemption for Employee Benefit Plans

(a) The restrictions of sections 406(a) and 407(a) of the Act and the sanctions resulting from the application of section 4975 of the Code by reason of section 4975(c)(1) (A) through (D) of the Code shall not apply to any acquisition or holding or qualifying employer securities of qualifying employer real property (other than through the Trust) by a Participating Plan if (1) the acquisition or holding constitutes a prohibited transaction solely by reason of being aggregated with employer securities or employer real property held by the Trust; (2) the requirements of either paragraph (a)(1) or paragraph (a)(2) of Section I of this exemption are met; and (3) the applicable conditions set forth in Section IV of this exemption are met.

Section III. Transfers of Real Property From Balcor to the Trust

(a) The restrictions of section 406(a), 406(b)(1) and (2) of the Act and the taxes imposed by section 4975 of the Code by reason of section 4975(c)(1)(A) through (E) of the Code shall not apply to any sale to the Trust of real property acquired by Balcor or an affiliate during the offering period if the following conditions are met:

(a) The price paid by the Trust for the property will be no greater than the lesser of the sum of the amount paid and the holding costs incurred by Balcor or an affiliate or the fair market value of the property, as determined by an independent appraiser, as of the date of sale to the Trust;

(b) The offering memorandum (Memorandum) is supplemented during the offering period with a description of the proposed investment;

(c) All documents relating to such an investment by Balcor indicate specifically that the investment is being made on behalf of the Trust and all documents relating to the calling of funds from investors specify the investment for which such funds will be used;

(d) All such transfers are completed within 120 days of purchase by Balcor or an affiliate; and

(e) The conditions set forth in section IV of this exemption are met.

Section IV. General Conditions

(a) At the time the transaction is entered into, and at the time of any subsequent renewal thereof that requires the consent of Balcor or its affiliate, the terms of the transaction are not less favorable to the Trust than the terms generally available in arm's-length transactions between unrelated parties.

(b) Balcor or its affiliates maintain for a period of six years from the date of the transaction the records necessary to enable the persons described in paragraph (c) of this Section IV to determine whether the conditions of this exemption have been met, except that (1) a prohibited transaction will not be considered to have occurred if, due to circumstances beyond the control of Balcor or its affiliates, the records are lost or destroyed prior to the end of the six-year period, and (2) no party in interest shall be subject to the civil penalty that may be assessed under section 502(i) and (j) of the Code, if the records are not maintained, or are not available for examination as required by paragraph (c) below.

(c)(1) Except as provided in section 2 of this paragraph (c) and

notwithstanding any provisions of subsections (a)(2) and (b) of section 408 of the Act, the records referred to in paragraph (b) of this Section IV are unconditionally available at their customary location for examination during normal business hours by:

(A) Any duly authorized employee or representative of the Department or the Internal Revenue Service.

(B) Any fiduciary of a Participating Plan who has authority to acquire or dispose of the interests in the Trust of the Participating Plan or any duly authorized employee or representative of such fiduciary.

(C) Any contributing employer to any Participating Plan or any duly authorized employee or representative of such employer, and

(D) Any participant or beneficiary of any Participating Plan, or any duly authorized employee or representative of such participant or beneficiary.

(2) None of the persons described in subparagraphs (B) through (D) of this paragraph (c) shall be authorized to examine trade secrets of Balcor or its affiliate, or commercial or financial information which is privileged or confidential.

Section V. Definitions and General Rules

For the purposes of this exemption,

(a) The term "the Trust" shall include any collective investment fund that may hereafter be established, operated and managed by Balcor or its affiliate in essentially the same manner as the Real Estate for American Labor A Balcor Group Trust.

(b) An "affiliate" of a person includes—

(1) Any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the person.

(2) Any officer, director, employee, relative of, or partner in any such person, and

(3) Any corporation or partnership of which such person is an officer, director, partner or employee.

(c) The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(d) The term "relative" means a "relative" as that term is defined in section 3(15) of the Act (or a "member of the family" as that term is defined in section 4975(e)(6) of the Code), or a brother, a sister, or a spouse of a brother or sister.

(e) The term "substantial employer" means for any plan year an employer (treating employers who are members of the same affiliated group, within the meaning of section 1563(a) of the Code, contributions to or under a multiemployer plan for each of—

(1) The two immediately preceding plan years, or

(2) The second and third preceding plan years, equaling or exceeding 10 percent of all employer contributions paid to or under that plan for each such year.

(f) The time as of which any transaction, acquisition or holding occurs is the date upon which the transaction is entered into, the acquisition is made or the holding commences. In addition, in the case of a transaction that is continuing, the transaction shall be deemed to occur until it is terminated. If any transaction is entered into, or an acquisition is made, on or after the effective date of this exemption, or a renewal that requires the consent of the Trust occurs on or after the effective date of this exemption, and the requirements of this exemption are satisfied at the time the transaction is entered into or renewed, respectively, or at the time the acquisition is made, the requirements will continue to be satisfied thereafter with respect to the transaction or acquisition and the exemption shall apply thereafter to the continued holding of the property so acquired. Notwithstanding the foregoing, this exemption shall cease to apply to transactions exempt by virtue of subsections I(a)(1) and I(c) at such time as the interest of the Participating Plan exceeds the percentage interest limitations set forth in these subsections, unless no portion of such excess results from an increase in the assets allocated to the Trust by the Participating Plan. For this purpose, assets allocated do not include the investment of Trust earnings. Nothing in this paragraph (f) shall be construed as exempting a transaction described in section 406 of the Act or section 4975 of the Code while the transaction is continuing, unless the conditions of the exemption were met either at the time the transaction was entered into or at the time the transaction would have become prohibited but for this exemption.

(g) Each Participating Plan shall be considered to own the same proportionate undivided interest in each asset of the Trust as its proportionate interest in the total assets of the Trust as calculated on the most recent preceding valuation date of the Trust.

The availability of this exemption is subject to the express condition that the material facts and representations contained in the application are true and complete, and that the application accurately describes all material terms of the transactions to be consummated pursuant to this proposed exemption.

facts and representations supporting the Department's decision to grant this exemption refer to the notice of proposed exemption published on July 29, 1988 at 53 FR 28715.

FOR FURTHER INFORMATION CONTACT: David Lurie of the Department, telephone (202) 523-8971. (This is not a toll-free number.)

PAGE 49296

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it effect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries.

(2) These exemptions are supplemental to and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(3) The availability of these exemptions is subject to the express condition that the material facts and representations contained in each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, DC, this 21st day of October, 1988.

Robert J. Doyle,

Acting Director of Regulations and Interpretations, Pension and Welfare Benefits Administration, U.S. Department of Labor.

[FR Doc. 88-24713 Filed 10-25-88; 8:45 am]

BILLING CODE 4510-29-M

D-6837

Pension and Welfare Benefits Administration

[Application No. D-6837]

Proposed Exemptions; Real Estate for American Labor A Balcor Group Trust (the Trust) et. al.

AGENCY: Pension and Welfare Benefits Administration, Labor.

ACTION: Notice of proposed exemptions.

SUMMARY: This document contains notices of pendency before the Department of Labor (the Department) of proposed exemptions from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

Written Comments and Hearing Requests

All interested persons are invited to submit written comments or requests for a hearing on the pending exemptions, unless otherwise stated in the Notice of Pendency, within 45 days from the date of publication of this Federal Register Notice. Comments and requests for a hearing should state the reasons for the writer's interest in the pending exemption.

D-6837

1877

ADDRESS: All written comments and requests for a hearing (at least three copies) should be sent to the Pension and Welfare Benefits Administration, Office of Regulations and Interpretations, Room N-5669, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210. Attention: Application No. stated in each Notice of Pendency. The applications for exemption and the documents received will be available for public inspection in the Public Documents Room of Pension and Welfare Benefit Programs, U.S. Department of Labor, Room N-4677, 200 Constitution Avenue, NW., Washington, DC 20210.

Notice to Interested Persons

Notice of the proposed exemptions will be provided to all interested persons in the manner agreed upon by the applicant and the Department within 15 days of the date of publication in the Federal Register. Such notice shall include a copy of the notice of pendency of the exemption as published in the Federal Register and shall inform interested persons of their right to comment and to request a hearing (where appropriate).

SUPPLEMENTARY INFORMATION: The proposed exemptions were requested in

applications filed pursuant to section 408(a) of the Act and/or section 4975(c)(2) of the Code, and in accordance with procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). Effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issued exemptions of the type requested to the Secretary of Labor. Therefore, these notices of pendency are issue solely by the Department.

The applications contain representations with regard to the proposed exemptions which are summarized below. Interested persons are referred to the applications on file with the Department for a complete statement of the facts and representations.

Real Estate for American Labor a Balcor Group Trust (the Trust), Located in Chicago, IL

[Application No. D-6837]

Proposed Exemption

Section I. Exemption for Certain Transactions Involving the Trust

(a) The restrictions of sections 406(a), 406(b)(2), and 407(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1) (A) through (D) of the Code, shall not apply to the transactions described below if the applicable conditions set forth in Section IV are met.

(1) *Transactions Between Parties-in-Interest and the Trust Generally.* Any transaction between a party-in-interest with respect to a plan which has an interest in the Trust (a Participating Plan) and the Trust, or any acquisition or holding by the Trust of employer securities or employer real property, if the party in interest is not Balcor Institutional Realty Advisors, Inc. (Balcor) or one of its affiliates, any other trust maintained by Balcor or one of its affiliates, and if, at the time of the transaction, acquisition or holding, the interest of the Participating Plan, together with the interest of any other Participating Plans maintained by the same employer or employee organization in the Trust, does not exceed 10 percent of the total of all assets in the Trust.

(2) *Special Transactions Not Meeting the Criteria of Section I(a)(1) Between Employers of Employees Covered by a Multiemployer Plan and the Trust.* Any transaction between an employer (or an affiliate of an employer) of employees covered by a multiemployer plan (as defined in section 3(37)(A) of the Act and section 414(f)(1) of the Code) that is a Participating Plan, and the Trust, or any acquisition or holding by the Trust of employer securities or employer real property, if at the time of the transaction, acquisition or holding—

The interest of the multiemployer plan in the Trust exceeds 10 percent of the total assets in the Trust, but the employer is not a "substantial employer" with respect to the plan and would not be a "substantial employer" if "5 percent" were substituted for "10 percent" in the definition of "substantial employer."

(3) *Acquisitions, Sales, or Holdings of Employer Securities and Employer Real Property.* (A) Except as provided in subsection (B) of this section (3), any acquisition, sale or holding of employer securities or employer real property by the Trust which does not meet the requirement of paragraphs (a)(1) and (a)(2) of this section I, if no commission is paid to Balcor or to the employer, or any affiliate of Balcor or the employer in connection with the acquisition or sale of employer securities or the acquisition, sale or lease or employer real property; and

(i) In the case of employer real property—

(aa) Each parcel of employer real property and the improvements thereon held by the Trust are suitable (or adaptable without excessive cost) for use by different tenants, and

(bb) The property of the Trust that is leased or held for lease to others, in the aggregate, is dispersed geographically.

(ii) In the case of employer securities—

(aa) Neither Balcor nor any of its affiliates is an affiliate of the issuer of the security, and

(bb) If the security is an obligation of the issuer, either:

1. The Trust owns the obligation at the time the plan acquires an interest in the Trust, and interests in the Trust are offered and redeemed in accordance with valuation procedures of the Trust applied on a uniform or consistent basis, or

2. Immediately after acquisition of the obligation by the Trust not more than 25 percent of the aggregate amount of obligations issued in the issue and outstanding at the time of acquisition is held by such plan, and at least 50 percent of the aggregate amount of obligations issued in the issue and outstanding at the time of acquisition is held by persons independent of the issuer. Balcor, its affiliates, and any collective investment fund maintained by Balcor or its affiliates, shall be considered to be persons independent of the issuer if Balcor is not an affiliate of the issuer.

(B) In the case of a Participating Plan that is not an eligible individual account plan (as defined in section 407(d)(3) of the Act), the exemption provided in subsection (A) of this section (3) shall be available only if, immediately after the acquisition of the securities or real property, the aggregate fair market value of employer securities and employer real property with respect to which Balcor or its affiliate has investment discretion does not exceed 10 percent of the fair market value of all the assets of the Participating Plan with respect to which Balcor or its affiliate has such investment discretion.

(C) For purposes of the exemption contained in subsection (A) of this section (3), the term "employer securities" shall include securities issued by, and the term "employer real property" shall include real property leased to, a person who is a party-in-interest with respect to a Participating Plan by reason of a relationship to the employer described in section 3(14) (E), (G), or (I) of the Act.

(b) The restrictions of section 406(a)(1)(A) through (D) and section 406 (b)(1) and (b)(2) of the Act and the sanctions resulting from the application of section 4975 of the Code by reason of section 4975(c)(1) (A) through (E) of the Code, shall not apply to the transactions described below, if the conditions of Section IV are met.

(1) *Certain Leases and Goods.* The furnishing of goods to the Trust by a party-in-interest with respect to a Participating Plan or the leasing of real property owned by the Trust to such party-in-interest and the incidental furnishing of goods to such party-in-interest by the Trust, if—

(A) In the case of goods, they are furnished to or by the Trust in connection with real property owned by the Trust;

(B) The party-in-interest is not Balcor, any affiliate of Balcor, or one of the other trusts and

(C) The amount involved in the furnishing of goods or leasing of real property in any calendar year (including the amount under any other lease or arrangement for the furnishing of goods in connection with the real property investments of the Trust with the same party-in-interest, or any affiliate thereof) does not exceed the greater of $25,000 or 0.5 percent of the fair market value of the assets of the Trust on the most recent valuation date of the Trust prior to the transaction.

(2) *Transactions Involving Pieces of Public Accommodation.* The furnishing

D-6837 2of7

of services, facilities and any goods incidental to such services and facilities by a place of public accommodation owned by the Trust to a party-in-interest with respect to a Participating Plan, if the services, facilities and incidental goods are furnished on a comparable basis to the general public.

(c) The restrictions of section 406(a)(1)(A) through (D) of the Act and the sanctions resulting from the application of section 4975 of the Code by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the following transactions if the conditions of section IV are met:

Any transaction between the Trust and a person who is a party in interest with respect to a Participating Plan, if—

(1) The person is a party in interest (including a fiduciary) solely by reason of providing services to the Participating Plan, or solely by reason of a relationship to a service provider described in section 3(14)(F), (G), (H) or (I) of the Act, or both, and the person neither exercised nor has any discretionary authority, control, responsibility or influence with respect to the investment of the Participating Plan's assets in, or held by, the Trust;

(2) At the time of the transaction, the interest of the Participating Plan, together with the interests of any other Participating Plan maintained by the same employer or employee organization in the Trust, does not exceed 20 percent of the total of all assets in the Trust; and

(3) The person is not Balcor or an affiliate of Balcor.

(d) The restrictions of section 406(a)(1)(A) through (D) of the Act and the sanctions resulting from the application of section 4975 of the Code by reasons of section 4975(c)(1)(A) through (D) of the Code shall not apply to the purchase and sale of units of beneficial interest (Units) in the Trust if no more than reasonable compensation is paid therefor and (a) each purchase and sale is authorized in writing by a fiduciary of the Participating Plan who is independent of Balcor and any of its affiliates or (b) the purchase or sale is a mandatory redemption required by the Trust Agreement, including the failure of the Participating Plan to remain a plan which can invest in a group trust described in section 401(a)(24) of the Code, and the applicable conditions of section IV are met.

Section II. Excess Holdings Exemption for Employee Benefit Plans

(a) The restrictions of section 406(a) and 407(a) of the Act and the sanctions resulting from the application of section 4975 of the Code by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property (other than through the Trust) by a Participating Plan if: (1) the acquisition of holding constitutes a prohibited transaction solely by reason of being aggregated with employer securities or employer real property held by the Trust; (2) the requirements of either paragraph (a)(1) or paragraph (a)(2) of section I of this exemption are met; and (3) the applicable conditions set forth in section IV of this exemption are met.

Section III. Transfers of Real Property From Balcor to the Trust

(a) The restrictions of section 406(a), 406(b)(1); and (2) of the Act and the taxes imposed by section 4975 of the Code by reason of section 4975(c)(1)(A) through (E) of the Code shall not apply to any sale to the Trust of real property acquired by Balcor or an affiliate during the offering period if the following conditions are met:

(a) The price paid by the Trust for the property will be no greater than the lesser of the sum of the amount paid and the holding costs incurred by Balcor or an affiliate or the fair market value of the property, as determined by an independent appraiser, as of the date of sale to the Trust;

(b) The offering memorandum (Memorandum) is supplemented during the offering period with a description of the proposed investment;

(c) All documents relating to such an investment by Balcor indicate specifically that the investment is being made on behalf of the Trust and all documents relating to the calling of funds from investors specify the investment for which such funds will be used;

(d) All such transfers are completed within 120 days of purchase by Balcor or an affiliate; and

(e) The conditions set forth in section IV of this exemption are met.

Section IV. General Conditions

(a) At the time the transaction is entered into, and at the time of any subsequent renewal thereof that requires the consent of Balcor or its affiliate, the terms of the transaction are not less favorable to the Trust than the terms generally available in arm's-length transactions between unrelated parties.

(b) Balcor or its affiliates maintain for a period of six years from the date of the transaction the records necessary to enable the persons described in paragraph (c) of this section IV to determine whether the conditions of this exemption have been met, except that:

(1) A prohibited transaction will not be considered to have occurred if, due to circumstances beyond the control of Balcor or its affiliates, the records are lost or destroyed prior to the end of the six-year period, and (2) no party in interest shall be subject to the civil penalty that may be assessed under section 502 (a) and (b) of the Code, if the records are not maintained, or are not available for examination as required by paragraph (c) below.

(c)(1) Except as provided in section 2 of this paragraph (c) and notwithstanding any provisions of subsections (a)(2) and (b) of section 504 of the Act, the records referred to in paragraph (b) of this section IV are unconditionally available at their customary location for examination during normal business hours by:

(A) Any duly authorized employee or representative of the Department or the Internal Revenue Service,

(B) Any fiduciary of a Participating Plan who has authority to acquire or dispose of the interests in the Trust of the Participating Plan or any duly authorized employee or representative of such fiduciary,

(C) Any contributing employer to any Participating Plan or any duly authorized employee or representative of such employer, and

(D) Any participant or beneficiary of any Participating Plan, or any duly authorized employee or representative of such participant or beneficiary.

(2) None of the persons described in subparagraphs (B) through (D) of this paragraph (c) shall be authorized to examine trade secrets of Balcor or its affiliate, or commercial or financial information which is privileged or confidential.

Section V. Definitions and General Rules

For the purposes of this exemption:

(a) The term "the Trust" shall include any collective investment fund that may hereafter be established, operated and managed by Balcor or its affiliate in essentially the same manner as the Real Estate for American Labor A Balcor Group Trust.

(b) An "affiliate" of a person includes—

(1) Any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the person,

(2) Any officer, director, employee, relative of, or partner in any such person, and

D-6837 3077

(3) Any corporation or partnership of which such person is an officer, director, partner or employee.

(c) The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(d) The term "relative" means a "relative" as that term is defined in section 3(15) of the Act (or a "member of the family" as that term is defined in section 4975(e)(6) of the Code), or a brother, a sister, or a spouse of a brother or sister.

(e) The term "substantial employer" means for any plan year an employer (treating employers who are members of the same affiliated group, within the meaning of section 1563(a) of the Code, determined without regard to section 1563(a)(4) and (e)(3)(c) of the Code, as one employer) who has made contributions to or under a multiemployer plan for each of—

(1) The two immediately preceding plan years, or

(2) The second and third preceding plan years, equaling or exceeding 10 percent of all employer contributions paid to or under that plan for each such year.

(f) The time as of which any transaction, acquisition or holding occurs is the date upon which the transaction is entered into, the acquisition is made or the holding commences. In addition, in the case of a transaction that is continuing, the transaction shall be deemed to occur until it is terminated. If any transaction is entered into, or an acquisition is made, on or after the effective date of this exemption, or a renewal that requires the consent of the Trust occurs on or after the effective date of this exemption, and the requirements of this exemption are satisfied at the time the transaction is entered into or renewed, respectively, or at the time the acquisition is made, the requirements will continue to be satisfied thereafter with respect to the transaction or acquisition and the exemption shall apply thereafter to the continued holding of the property so acquired. Notwithstanding the foregoing, this exemption shall cease to apply to transactions exempt by virtue of subsections I(a)(1) and I(c) at such time as the interest of the Participating Plan exceeds the percentage interest limitations set forth in those subsections, unless no portion of such excess results from an increase in the assets allocated to the Trust by the Participating Plan. For this purpose, assets allocated do not include the investment of Trust earnings. Nothing in this paragraph (f) shall be construed as exempting a transaction described in section 408 of the Act or section 4975 of the Code while the transaction is continuing, unless the conditions or the exemption were met either at the time the transaction was entered into or at the time the transaction would in the become prohibited but for this exemption.

(g) Each Participating Plan shall be considered to own the same proportionate undivided interest in each asset of the Trust as its proportionate interest in the total assets of the Trust as calculated on the most recent preceding valuation date of the Trust.

The availability of this exemption is subject to the express condition that the material facts and representations contained in the application are true and complete, and that the application accurately describes all material terms of the transactions to be consummated pursuant to this proposed exemption.

Preamble

On July 23, 1980, the Department published a class exemption, Prohibited Transaction Exemption 80-51 (PTE 80-51, 45 FR 49708), which permits collective investment funds that are maintained by banks and in which employee benefit plans participate to engage in certain transactions provided that specified conditions are met. The transactions for which the applicants have requested relief are those which, in part, are the subject of PTE 80-51.

The Department stated in PTE 80-51, that a comment had been received to the proposed class exemption requesting that it be amended to apply to collective investment funds that are not maintained by banks. Relief was granted for bank collective investment funds because, among other reasons, such funds are regulated by other governmental agencies and constitute a well-defined class of funds. In the case of collective investment funds that are not maintained by banks, the Department found that the record was insufficient to determine the nature of the funds and the entities managing the funds that would comprise the class covered by such broad relief. As a result, the Department stated that it could not make the required statutory findings for such relief, and that relief for non-bank maintained collective investment funds should be dealt with on an individual rather than a class basis.

To date the Department has proposed and granted various individual exemptions on behalf of collective investment funds which have not qualified for relief under PTE 80-51 or Prohibited Transaction Exemption 78-19 (PTE 78-19, 43 FR 59915, December 29, 1978; class relief on behalf of pooled separate accounts sponsored by insurance companies). Such individual exemptions have provided relief for similar transactions subject to, in most instances, similar terms and conditions as those contained in the class exemptions.

Summary of Facts and Representations

1. The Trust is intended to be a group trust described in section 401(a)(24) of the Code and Rev. Rul. 81-100, 1981-1 C.B. 326, to provide multiemployer plans (as defined in section 3(37)(A) of the Act and section 414(f)(1) of the Code) a vehicle for pooling a portion of their funds for the purpose of making investments in real estate and mortgage loans. The Trust is intended to be qualified under section 401(a) of the Code and exempt from tax under section 501(a) of the Code.

2. Pursuant to a written investment management agreement entered into with the trustees (the Trustees) of the Trust, Balcor will serve as the investment manager for the Trust. Prior to the offering of Units, Balcor, a newly formed corporation, will acquire all of the partnership interests of and become successor to Balcor Real Estate Investment Advisors, a registered investment advisor. Thereafter, Balcor will become an investment advisor registered under the Investment Advisors Act of 1940. The Balcor Company (Balcor Co.) owns all of the outstanding shares of Balcor and will unconditionally guarantee payment of all of the liabilities of Balcor. Balcor Co. and its subsidiaries have shareholder's equity in excess of $150,000,000 and manage property valued at more than $3,000,000,000. Balcor Co. is a wholly-owned subsidiary of Shearson Lehman Brothers, Inc. (Shearson), an investment banking and brokerage firm and an investment advisor, among other entities. Shearson is wholly-owned by American Express Company, which is primarily in the business of providing travel related services, insurance services, and international banking services. Affiliates of Balcor Co. have formed numerous public and private real estate entities. In addition, Balcor Co. and its affiliates manage or advise additional public and private real estate entities, as well as entities not engaged in the real estate business. They also engage in other business activities. Any successor investment manager will be chosen by a majority of the Trustees. Balcor expects to manage additional funds in the future which will be structured similarly to the

D-6837

Trust. Pursuant to the investment management agreement, Balcor will be vested with the exclusive authority to acquire, manage and dispose of the Trust's investments in real property. Balcor will be responsible for performing the day-to-day administrative and investment operations of the Trust. Balcor will directly or through an affiliate, provide property acquisition, maintenance and repair, rent collection, bookkeeping, lease negotiation, mortgage brokerage and servicing and other related management services. Balcor is not currently a qualified professional asset manager as defined in Prohibited Transaction Exemption 84-14 (PTE 84-14, 49 FR 9494) since it does not yet have $50 million of assets under management. Messrs. Jerry M. Reinsdorf, Stephen H. Silverstein, John L. West, Barry R. Jackson, Van L. Pell and Thomas E. Meador serve as the Trustees. The Trustees are officers of Balcor or an affiliate. The Trustees will receive no compensation for serving as Trustee. They will be solely responsible for accepting or rejecting participation in the Trust by a prospective Participating Plan, determining the fair market value of the Trust's assets for the purpose of valuing Units, and determining the time and amount of distributions to Participating Plans.

4. Interests in the Trust will be offered pursuant to the Memorandum, which describes the management, operation, investment objectives and income tax consequences of the Trust and compensation to be paid to Balcor as investment manager. The initial offering price of each Unit is $100,000, with a minimum subscription by an investor of 10 Units. The offering price per Unit will be adjusted to reflect quarterly re-evaluations of the Units. There is no minimum or maximum total offering of Units, although the Trust will only accept payment for Units for which it has received investor commitments or subscriptions when subscriptions for at least 200 Units ($20,000,0000) have been accepted by the Trustees. In order to avoid making short-term investments for the Trust, Balcor will not call commitments to invest in the Trust until it has made appropriate investments on behalf of the Trust equal to the amount of the commitments. If such investments are not made within 15 months after obtaining the initial $20,000,000 of commitments, each investor will be offered the right to rescind its commitment. Afterward, the process will be repeated for each $10,000,000 in commitments and investments. The Trust provides that Balcor or an affiliate may, for the purpose of facilitating the acquisition of an investment by the Trust, make or acquire an investment in its own name and within 120 days transfer such investment to the Trust. The price will be no greater than the lesser of the sum of the amount paid and the holding costs incurred by Balcor or an affiliate or the fair market value of the investment, as determined by an independent appraiser, as of the date of sale to the Trust. It is contemplated that Units will be offered for an indefinite period which is not expected to exceed ten years. After that time, Units will only be offered to current Participating Plans and no new investors will be permitted unless such investor is purchasing Units which are being redeemed. The Units will be privately offered commencing on or about September 15, 1988 and will not be registered under the Securities Act of 1933. Neither the Units nor any interest therein may be resold, transferred, assigned, or otherwise disposed of or encumbered by Participating Plans, as required by Rev. Rul. 81-100.

4. The decision of any plan to invest in the Trust will be made by fiduciaries of that plan. The Trustees may reject a subscription for any reason. The applicant states that none of the individual Trustees of the Trust, nor any of the employees, officers, directors or shareholders of Balcor or its affiliates will exercise any discretionary authority over or otherwise participate in the decision of any plan to invest in the Trust. In connection with the proposed exemption for the purchase and sale of Units in the Trust, the applicant represents that Balcor or its affiliates may act as an investment adviser or investment manager with respect to portions of the assets of plans that may become Participating Plans and may on occasion be retained by such plans to provide services with respect to specific real estate investments made by the plans. However, the applicant represents further that assets of plans for which Balcor or any of its affiliates acts as investment adviser or investment manager or otherwise subject to the investment discretion of Balcor or any of its affiliates will not be eligible for investment in the Trust. In addition, Balcor expects to engage in normal marketing and promotional activity in connection with the Trust, but it will not recommend investment therein of plan assets with respect to which it acts as an investment adviser or investment manager.[1]

[1] To the extent that, in the ordinary course of business, Balcor or any of its affiliates provides "investment advice" to a Participating Plan within the meaning of regulation 29 CFR 2510.3-21(c)(1)(i)(B) and recommends an investment of a plan's assets in the Trust, the presence of an unrelated second fiduciary acting on the recommendations of the investment adviser's recommendations on behalf of the plan is not sufficient to insulate the advisers from fiduciary liability under section 406(b) of the Act. (See Advisory Opinions 84-03A and 84-04A, issued by the Department on January 4, 1984). The Department is unable to conclude that fiduciary self-dealing of the type [if present] is in the interests of, or protective of, plans and their participants and beneficiaries and, accordingly, has limited the availability of exemptive relief for the acquisition or sales of Units in the Trust to section 406(a) violations only.

5. The Trustees, in their sole discretion, may terminate the Trust at any time. Upon termination, the Trustees are required to liquidate the Trust's properties and distribute its assets to Participating Plans, pro rata, subject to appropriate reserves for existing liabilities and contingencies.

6. A Participating Plan may request that the Trust redeem all or any portion of its Units. Furthermore, under certain circumstances described below, the Units of a Participating Plan may be involuntarily redeemed.

The Trustees will make redemption payments out of available funds and will be under no obligation to sell any properties to satisfy redemption requests. However, the Trust may not enter into any new commitments to purchase properties or make new mortgage loans if any redemption requests are outstanding unless the Trustees determine that a redemption at that time will violate the conditions of the Trust Agreement. Upon receipt of the redemption request the Trustees may, in their discretion, notify all remaining Participating Plans of the availability of additional Units that may be purchased at the existing Unit asset value as of the date of redemption. If remaining Participating Plans do not purchase all the Units being redeemed, the Trustees may, in their discretion, offer the remaining Units to other eligible investors. Upon the redemption date, the Trustees will distribute to the redeeming Participating Plan the existing Unit asset value as of the date the Units are redeemed. The redemption price will be decreased by any estimate of the costs of disposition of assets the proceeds of which are used to redeem Units, which costs are not reflected in such Unit asset value.

Upon termination of the status of a Participating Plan as a qualified trust under section 401(a) of the Code or upon amendment of the Participating Plan so that it is no longer authorized to invest in the Trust, the Units held by such Participating Plan shall be deemed to have been redeemed as of the

D-6837

coincident or preceding Valuation Date. As funds are made available, the Trustees will distribute to such Participating Plan 90% of the Unit asset value of the Units which were redeemed, decreased by any costs of redemption. Ten percent of the value of the Units being redeemed will be placed in an interest bearing escrow account and treated as a contingent liability of the Trust for seven years. At the end of seven years, the Trustees will compare the Unit value at that time with 90% of the Unit value at the time of the redemption (the Settlement Value). If the Unit value is less than the Settlement Value, the contingent liability will be eliminated, with no additional payment to the Participating Plan which had Units which were subject to a mandatory redemption. If the Unit value is greater than the Settlement Value, the former Participating Plan will be refunded some or all of the retained ten percent, including interest on that amount, up to the current Unit value.

The applicant represents that in the event of such a mandatory redemption, the Trust will be obligated to repurchase the Units held by such Participating Plan in order to maintain its tax-exempt status. The need to repurchase such Units could disrupt the investment portfolio and Balcor's strategy and adversely affect the return on the investments of the other Participating Plans. The Trust therefore requires that the Participating Plan which causes a mandatory redemption to bear a greater share of the risk of loss caused by the redemption. If there are no adverse consequences to the Trust, the 10% retained interest will be paid out to such Participating Plan after seven years, which is the expected turnover time of the Trust's portfolio.

Upon the Trustees' determination that the Trust will be engaged in a non-exempt prohibited transaction because of a Participating Plan's acquisition or ownership of Units, such Units will be subject to a mandatory redemption as described in the preceding paragraph, except that there will be no ten percent retention.

7. The purposes of the Trust are preserving and protecting capital, generating income on investments, providing for capital appreciation and providing jobs for union labor. Consistent with these purposes, funds of the Trust will be invested in direct or indirect ownership, contract, or leasehold interests in (1) Realty currently or soon to be under construction or rehabilitation, (2) land underlying realty described in (1) above, and (3) realty the investment of which is incidental to investments described in (1) and (2) above. Funds of the Trust will also be invested in direct or indirect interests in loans or commitments to make loans related to the types of realty described above.

8. All investments will be evaluated by Balcor in accordance with Balcor's investment criteria and must offer a commercially competitive rate of return. A requirement for all investments by the Trust in realty or in loans thereon is that the construction or rehabilitation by the developers must be provided by contractors and sub-contractors who employ union labor, defined as laborers who are members of United States labor unions and registered with the Department of Labor or who are covered by collective bargaining agreements. Where some laborers are required on a project but cannot satisfy the foregoing condition, work will be deemed to be performed by union labor if the building trades council or other body representing union trades in the locale of the realty being developed approves or endorses the plan of construction by a mix of union and non-union labor. The seller or borrower must provide, as a condition to receiving assets of the Trust, a commitment of the developer or general contractor that all labor will be provided by union labor or, where that condition cannot be satisfied, in accordance with such plan of construction approved by the local building trades council or other body.[1]

Financing applications will be individually considered and accepted Balcor after it is determined that they satisfy the investment criteria. The applicant represents that Balcor or its affiliates seek similar types of investments (i.e., forward-commitmer first mortgage loans on commercial properties) without regard for whethe union labor will be used for several funds or client accounts managed by Balcor and its affiliates. Balcor theref seeks such investments generally, anc will allocate those that first meet its financial investment standards among the funds and accounts on the basis o which fund or account committed mor first. Whether a project uses union lab will be a factor only to determine if th investment should be allocated to the Trust. Balcor will consider financing applications without regard to the identity of the general contractors or t subcontractors who may potentially b selected (or who may already have be selected if such selection was made prior to submission of the financing application). Neither Balcor nor any affiliate thereof will develop, rehabilitate or contract or subcontract develop or rehabilitate the realty in which the Trust has an interest. Balco will not be directly involved in the process of selecting contractors, subcontractors or providers of goods, services or facilities, as selection will made by the developer or general contractor, neither of which will be affiliated with the Trustees or Balco. However, Balcor may establish and administer guidelines regarding the terms of such selection process to ensure prudent selection and compliance with the investment objectives, policies and limitations of the Trust. Balcor's decisions on the issuance of loans are final.

9. Balcor's investment criteria will contain no requirement that the real estate underlying investments be with any specific locales, and it is expectec that the investments will be geographically dispersed. Therefore, there will be no obligation on the part Balcor to invest in areas where employers whose employees are covered by the Participating Plans are located. Similarly, there is no obligatic on the part of Balcor to invest funds of the Trust in realty which is under

[1] The Department notes that to the extent the fiduciaries of the Participating Plans restrict their consideration of investment opportunities for non-economic reasons, such conduct may involve certain violations of Part 4 of Title I of the Act which violations if present would not be provided relief by this exemption.

In this regard, section 404(a)(1) of the Act requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. To act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan. Because the investments made by the Trust are investments which would be selected, if at all, in preference to alternative investments, such an investment would not be prudent if it provided the Participating Plans with less return, in comparison to risk, than comparable investments available to the Plans, or if it involved a greater risk to the security of Plan assets than other investments offering a similar return.

The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment may n be influenced by a desire to stimulate the real esta industry and generate employment, unless the investment, when judged solely on the basis of it economic value to the plan, would be equal or superior to alternative investments available to t plan. (See Advisory Opinion 85-12A, January 1? 1985).

D-4837

construction or to be rehabilitated by employers whose employees are covered by a Participating Plan. The requirement that the developer have construction provided by contractors or subcontractors who employ union laborers is a general requirement and not tied to laborers represented by unions whose members are covered by a Participating Plan.

10. Balcor as investment manager will receive a single fee for its management services, including property management, equal to 1.45% per annum of the net value of investments in real property or loans. No additional fees, commissions or compensation will be paid by the Trust to Balcor or any of its affiliates. However, Balcor or its affiliates will be reimbursed by the Trust for certain costs and expenses, including travel, appraisal and other out-of-pocket expenses incurred in connection with administration of the Trust and property evaluation, negotiation, operation or disposition. The Trust will also pay costs of on-site building management personnel and office space, leasing fees paid to third parties and other fees for professional and technical services. Balcor will pay all fees and expenses in connection with the organization of the Trust and the offering of Units. The fee arrangement will be fully disclosed in the Trust Agreement and Memorandum and will be known to the fiduciaries of each of the Participating Plans at the time of their decision to invest in the Trust.

11. The books and records of the Trust will be audited by an independent certified public accountant each fiscal year. Copies of such reports and other pertinent information, including a summary of fees and expenses, report of acquisitions and appraisals and schedules of net asset and unit values, will be forwarded to each Participating Plan. Trust assets will be valued by the Trustees quarterly based on valuations by independent evaluators or appraisers. Each real property owned by the Trust will be appraised annually by an independent appraiser.

12. Because each Participating Plan will incorporate as part of such plan the terms, provisions, and conditions of the Trust agreement, the Trust will occupy a position equivalent to the trust created under such Participating Plan. Accordingly, pursuant to Revenue Ruling 81-100, it is the position of the Department that a "party in interest" as defined in the Act, or a "disqualified person" as defined in the Code, with respect to a Participating Plan may be viewed as a party in interest or disqualified person with respect to the Trust. Thus, a transaction between such party and the Trust may be viewed as a prohibited transaction as described in section 406(a) of the Act, section 4975(c) of the Code, or both. The applicant represents that if the Trust is unable to enter into transactions with certain persons because such persons are parties in interest with respect to a Participating Plan, the Trust's ability to prudently make its investments and conduct its operations solely for the benefit of the Participating Plans will be unduly restricted. In addition, the purchase and sale of Units in the Trust may be considered a prohibited sale or transfer of assets between a Participating Plan and the Trustees that is not exempted by operation of the statutory exemption provided in section 408(b)(8) of the Act because the Trust is not maintained by a bank or an insurance company.

13. The applicant requests prospective exemptive relief for many of those classes of transactions between the Trust and certain parties in interest which were afforded exemptive relief in PTE 80-51. The applicant proposes that such classes of transactions be subject to similar conditions, limitations, and restrictions as those delineated with respect to those transactions afforded exemptive relief in PTE 80-51.

14. In summary, the applicant represents that the proposed exemption for certain transactions between the Trust and certain parties in interest satisfies the criteria of section 408(a) of the Act because: (a) The proposed exemption would allow the Trust to enter into transactions which, although prohibited, are necessary for the Trust to prudently make its investments and conduct its operations solely for the benefit of its Participating Plans and their participants and beneficiaries; (b) the proposed exemption would primarily apply to various classes of prohibited transactions which were afforded relief in PTE 80-51 and would be subject to similar conditions, limitations and restrictions as those delineated with respect to those transactions afforded exemptive relief in PTE 80-51; and (c) independent fiduciaries, unrelated to the Trust, the Trustees, Balcor or any other related party, will maintain complete discretion with respect to investment of the Participating Plan's assets in the Trust.

For Further Information Contact: David Lurie of the Department, telephone (202) 523-8671. (This is not a toll-free number.)

PAGE 28727

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the

PAGE 28728

employees of the employer maintaining the plan and their beneficiaries;

(2) Before an exemption may be granted under section 408(a) of the Act and/or section 4975(c)(2) of the Code, the Department must find that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries and protective of the rights of participants and beneficiaries of the plan; and

(3) The proposed exemptions, if granted, will be supplemental to, and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(4) The proposed exemptions, if granted, will be subject to the express condition that the material facts and representations contained in each application are true and complete, and that each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, DC, this 26th day of July 1988.

Robert J. Doyle,

Acting Director of Regulations and Interpretations, Pension and Welfare Benefits Administration, U.S. Department of Labor.

[FR Doc. 88-17175 Filed 7-28-88; 8:45 am]

BILLING CODE 4510-29-M

D-6837

Federal Register / Vol. 54, No. 93 / Wednesday, May 24, 1989 / Notices 22503

[Prohibited Transaction Exemption 89-37; Exemption Application No. D-7521 et al.]

Grant of Individual Exemptions; Union Bank, et al.

AGENCY: Pension and Welfare Benefits Administration, Labor.

ACTION: Grant of individual exemptions.

SUMMARY: This document contains exemptions issued by the Department of Labor (the Department) from certain of the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

Notices were published in the Federal Register of the pendency before the Department of proposals to grant such exemptions. The notices set forth a summary of facts and representations contained in each application for exemption and referred interested persons to the respective applications for a complete statement of the facts and representations. The applications have been available for public inspection at the Department in Washington, DC. The notices also invited interested persons to submit comments on the requested exemptions to the Department. In addition the notices stated that any interested person might submit a written request that a public hearing be held (where appropriate). The applicants have represented that they have complied with the requirements of the notification to interested persons. No public comments and no requests for a hearing, unless otherwise stated, were received by the Department.

The notices of pendency were issued and the exemptions are being granted solely by the Department because, effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type proposed to the Secretary of Labor.

Statutory Findings

In accordance with section 408(a) of the Act and/or section 4975(c)(2) of the Code and the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 25, 1975), and based upon the entire record, the Department makes the following findings:

(a) The exemptions are administratively feasible;

(b) They are in the interests of the plans and their participants and beneficiaries; and

(c) They are protective of the rights of the participants and beneficiaries of the plans.

Union Bank (the Bank) Located in Los Angeles, California

[Prohibited Transaction Exemption 89-37; Exemption Application No. D-7521]

Exemption

The restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1) (A) through (D) of the Code, shall not apply to: (1) The proposed use of assets from certain multi-employer pension plans (the Plans), for which the Bank serves as a directed trustee, directed corporate trustee, directed corporate co-trustee, or custodian, for permanent mortgage loans to persons (the Borrowers), who will use the loan proceeds to pay off construction loans originated by the Bank; and (2) the execution and consummation of tri-party buy-sell agreements for such mortgage loans by the Bank with the Borrowers and the Plans, and the subsequent assignment of mortgage notes by the Bank to the Plans pursuant to such agreements, provided that:

A. Each permanent mortgage loan is expressly approved by a fiduciary independent of the Bank who has authority to manage or control those Plan assets being invested;

B. The terms of each transaction are no less favorable to the Plan than the terms generally available in an arm's-length transaction between unrelated parties; and

C. No investment management fee, advisory fee, underwriting fee, sales commission or similar compensation is paid to the Bank by the Plan with regard to such transaction.

For a more complete statement of the facts and representations supporting the Department's decision to grant this exemption refer to the notice of proposed exemption published on March 15, 1988 at 54 FR 10731.

Temporary Nature of Exemption: This exemption is effective only for those loans which are originated within five years of the date on which this exemption is published in the Federal Register.

FOR FURTHER INFORMATION CONTACT: Mr. E.F. Williams of the Department, telephone (202) 523-8883. (This is not a toll-free number.)

PAGE 22504

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401 (a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) These exemptions are supplemental to and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(3) The availability of these exemptions is subject to the express condition that the material facts and representations contained in each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, DC, this 19th day of May, 1989.

Robert J. Doyle,

Director of Regulations and Interpretations, Pension and Welfare Benefits Administration, U.S. Department of Labor.

[FR Doc. 89-12290 Filed 5-23-89; 8:45 am]

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89-37
D-7521

[Application No. D-7521 et al.]

Proposed Exemptions: Union Bank, et al.

AGENCY: Pension and Welfare Benefits Administration, Labor

ACTION: Notice of proposed exemptions.

SUMMARY: This document contains notices of pendency before the Department of Labor (the Department) of proposed exemptions from certain of the prohibited transaction restrictions of the Employee Reurement Income Security Act of 1974 (the Act) and/or the Internal Revenue Code of 1954 (the Code).

D-7521
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Written Comments and Hearings Requests

All interested persons are invited to submit written comments or requests for a hearing on the pending exemptions, unless otherwise stated in the Notice of Pendency, within 45 days from the date of publication of this **Federal Register** Notice. Comments and requests for a hearing should state the reasons for the writer's interest in the pending exemption.

ADDRESS: All written comments and requests for a hearing (at least three copies) should be sent to the Pension and Welfare Benefits Administration, Office of Regulations and Interpretations, Room N-5671, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20210. Attention: Application No. stated in each Notice of Pendency. The applications for exemption and the comments received will be available for public inspection in the Public Documents Room of Pension and Welfare Benefit Programs, U.S. Department of Labor, Room N-5507, 200 Constitution Avenue NW., Washington, DC 20210.

Notice of Interested Persons

Notice of the proposed exemptions will be provided to all interested persons in the manner agreed upon by the applicant and the Department within 15 days of the date of publication in the **Federal Register**. Such notice shall include a copy of the notice pendency of the exemption as published in the **Federal Register** and shall inform interested persons of their right to comment and to request a hearing (where appropriate).

SUPPLEMENTARY INFORMATION: The proposed exemptions were requested in applications filed pursuant to section 408(a) of the Act and/or section 4975(c)(2) of the Code, and in accordance with procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). Effective December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type requested to the Secretary of Labor. Therefore, these notices of pendency are issued solely by the Department.

The applications contain representations with regard to the proposed exemptions which are summarized below. Interested persons are referred to the applications on file

with the Department for a complete statement of the facts and representations.

Union Bank (the Bank) Located in Los Angeles, California

[Application No. D-7521]

Proposed Exemption

The Department is considering granting an exemption under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975). If the exemption is granted the restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to: (1) The proposed use of assets from certain multi-employer pension plans (the Plans), for which the Bank serves as a directed trustee, directed corporate trustee, directed corporate co-trustee, or custodian, for permanent mortgage loans to persons (the Borrowers), who will use the loan proceeds to pay off construction loans originated by the Bank; and (2) the execution and consummation of tri-party buy-sell agreements for such mortgage loans by the Bank with the Borrowers and the Plans, and the subsequent assignment of mortgage notes by the Bank to the Plans pursuant to such agreements, provided that:

A. Each permanent mortgage loan is expressly approved by a fiduciary independent of the Bank who has authority to manage or control those Plan assets being invested;

B. The terms of each such transaction are no less favorable to the Plan than the terms generally available in an arm's-length transaction between unrelated parties; and

C. No investment management, advisory, underwriting or sales commission or similar compensation is paid to the Bank by the Plan with regard to such transaction.

Temporary Nature of Exemption

This exemption, if granted, will be effective only for those loans which are originated within five years of the date on which the Final Grant of this proposed exemption is published in the Federal Register.

Summary of Facts and Representations

1. The Bank serves as a directed trustee, directed corporate trustee, directed corporate co-trustee, or custodian of the Plans. The Plans are 19 multiemployer construction trade Taft-Hartley pension funds with assets of approximately $2.5 billion. The Bank's services to the Plans consist of holding, receiving, handling and disbursing funds as instructed by an independent plan fiduciary. The Bank represents that it has no discretionary authority with respect to the management of assets of the Plans and does not render investment advice with regard to the permanent loans made by the Plans.[1] The Bank states that the only fiduciary relationship it has with the Plans is that of a directed trustee, directed corporate trustee, directed corporate co-trustee, or custodian for such Plans.

2. In the ordinary course of its commercial lending activities, the Bank makes construction loans to the Borrowers, who develop real property for projects such as office buildings, shopping centers, apartment houses, condominium developments, etc. The Bank states that it is one of the leading banks in California in making construction loans and that the borrowers are some of the leading developers in California. The Borrowers, without the assistance of the Bank, normally obtain a commitment for a permanent loan to pay off the Bank's construction loan when the particular project is completed. However, the Bank states that the Plans are precluded from making such permanent loans, as investment for their real estate portfolios, when the Bank is the construction lender for the project. Thus, the Plans must either forego these real estate investment opportunities or remove the Bank as a trustee, corporate trustee, corporate co-trustee, or custodian.

3. The Bank requests an exemption to permit the use of assets of the Plans for permanent loans to the Borrowers, who will use the loan proceeds to pay off the construction loans originated by the Bank. The Plans do not propose to originate any construction loans or to participate in any construction loans originated by the Bank. The Bank states that none of the Borrowers will be parties in interest with respect to the Plans. The Bank also states that no contributing employers of the Plans participate as contractors or subcontractors on any of the projects which are being financed by the Plans' permanent loans.[2]

4. The Bank represents that no loan origination fees will be paid by the Borrowers to the Bank for permanent financing. The Borrower will obtain commitments for permanent financing either through direct contacts with the Plans or through mortgage bankers. The Banks states that it occasionally acts a broker, for a fee, in order to find a permanent lender for a project. However, the Bank represents that it never acted as such a broker for any employee benefit plan for which it acts as a fiduciary and that, in the proposed transaction, the Borrowers will not authorize the Bank to act as an agent for the Borrower to obtain permanent financing for any project.

All of the permanent loans to the Borrowers will be originated by the Plans. Therefore, all loan origination fees will be paid to the Plans. In addition, the Bank states that the Plans will not be required to pay any advisory investment management, or loan commitment fee to the Bank, although such loans will be treated as assets for the normal directed trustee or custodial administration fees which will be assessed by the Bank. However, the Plans may request the Bank to service the permanent loans, for which the Bank will receive a servicing fee.[3]

5. The Bank represents that in some instances, the Plans and the Borrowers may want the construction loan and the permanent loan to be documented in the same package. In such instances, the parties will enter into a buy/sell arrangement. Such buy/sell arrangements will involve a written tri-party agreement between the Borrowers, the Bank (as construction lender), and the Plan (as permanent lender). There will be no tri-party agreements with mortgage bankers. The tri-party agreement will set forth the terms and conditions of both the construction lo

[1] To the extent that, in the ordinary course of business, the Bank or any of its affiliates provides "investment advice" to an employee benefit plan within the meaning of regulation 29 CFR 2510.3-21(c)(1)(ii)(B) and recommends an investment of the plan's assets as a permanent loan where the proceeds will be used to pay off a construction loan originated by the Bank, the presence of an unrelated second fiduciary acting on the Bank's recommendations on behalf of the plan would not be sufficient to insulate the Bank from fiduciary liability under section 406(b) of the Act. (See Advisory Opinions 84-03A and 84-04A, issued by the Department on January 4, 1984). The Department is unable, as a general matter, to conclude that fiduciary self-dealing of the type (if present) is in the interest or protective of a plan and its participants and beneficiaries. Thus, the Department has limited the exemptive relief for the proposed use of the proceeds of the Plans' permanent loans to section 406(a) violations only.

[2] The Department notes that where the construction on the property which secures a mortgage loan made by the Plan was conducted a contributing employer, and a principal of such employer exercises fiduciary authority to appoint the Plan's investment in the mortgage, a prohibited transaction may occur which would not be covered by this exemption.

[3] The Bank states that all servicing arrangements for the Plans' permanent loan portfolios would comply with section 408(b)(2) of the Act and the regulations thereunder.

D-7521

and the permanent loans. When the Plan makes a commitment to provide a permanent loan for a project upon completion of its construction, pursuant to a buy-sell arrangement, the tri-party agreement will commit the Borrower to us the proceeds of the permanent loan to repay the Bank's construction loan.

In all cases, the Bank as construction lender will have a lien interest in the property which is the subject of the Plans permanent loan commitment. In the absence of a buy-sell arrangement, the Bank states that when its construction loan is paid off with the proceeds of the Plan's permanent loan, the Bank will convey its lien interest in the property to the Borrower, who will simultaneously convey the lien interest to the Plan. However, in a buy/sell arrangement, the Bank will "sell" or assign the existing lien, including the mortgage note and supporting documents, to the Plan. The Bank states that in no case will it advance funds to the Borrower under the permanent loan.

6. The Bank represents that it will not be involved in the decision by the Plans to invest in any permanent loan on a real estate project. In all cases, independent Plan fiduciaries and investment advisers will review the proposed transactions and will examine the interest rates, financial statements, projected returns, appraisals and other factors relating to the investment before advising the Plan to make a permanent loan. The Bank will be subject to the investment directions of the investment managers and advisers for the Plans.

With respect to the construction loans originated by the Bank, the Bank states that it may require the Borrowers to furnish certain information, such as a list of all material dealers, laborers and subcontractors with whom agreements have been made by either the general contractor or the Borrower regarding the construction for a particular project. The Bank requests such information in order to evaluate the credit worthiness of the transactions. However, the Bank states that because it is not involved in the process by which the Plans decide whether to provide permanent financing for particular projects, it will not be aware of any non-economic factors that may be considered by the Plans' fiduciaries in making the investments, such as a requirement that construction on a particular project be performed by contractors and subcontractors who employ only union construction labor.[4]

7. The Bank states that investments by the Plans in real estate projects as permanent lenders are common in the current real estate financing market. The Bank also asserts that the proposed exemption is appropriate for the transactions described herein because of the absence of potential for abuse by the Bank and because a denial would unduly restrict the Plan's choices of potential Borrowers to those who have not secured a construction loan from the Bank, which is merely a directed trustee, directed corporate trustee, directed corporate co-trustee, or custodian for the Plans. The Bank represents that there will be no scheme or arrangement, other than an arm's-length tri-party agreement, between the Borrowers, the Bank, and the Plans regarding the proposed construction and permanent loan financing.

8. In summary, the Bank represents that the proposed transactions will satisfy the statutory criteria of section 408(c) of the Act because: (a) the Bank will have no discretionary authority regarding the management or disposition of the assets of the Plans and will not be an investment adviser for the Plans with respect to the proposed loans; (b) the fiduciaries of the Plans, who are independent of the Bank, will make all investment decisions for the Plans, including all decisions relating to the proposed permanent loans; (c) the terms of the permanent mortgage loans will be no less favorable to the Plan than the terms generally available in arm's-length transactions between unrelated parties; (d) no investment management fee, advisory fee, underwriting fee, sales commission, or other similar compensation will be paid to the Bank by the Plans with respect to such transactions; (e) the Bank will play no role in securing permanent loans from the Plans for the Borrowers; and (f) no permanent loans will be made to persons who are parties in interest with respect to the Plans.

For Further Information Contact: Mr. E.F. Williams of the Department's telephone (202) 523-8883 (This is a toll-free number.)

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General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and/or the Code, including any prohibited transaction provisions to which the exemption may not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) Before an exemption may be granted under section 408(a) of the Act and/or section 4975(c)(2) of the Code, the Department must find that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries and protective of the rights of participants and beneficiaries of the plan; and

(3) The proposed exemptions, if granted, will be supplemental to, and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(4) The proposed exemptions, if granted, will be subject to the express condition that the material facts and representations contained in each application are true and complete, and that each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, DC, this 10th day of March 1989.

Robert J. Doyle,

Director of Regulations and Interpretations, Pension and Welfare Benefits Administration.

[FR Doc. 89-6008 Filed 3-14-89; 8:45 am]

BILLING CODE 4510-29-M

[4] The Department notes that section 404(a)(1) of the Act requires, among other things, that a fiduciary of a plan must act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries when making investment decisions on behalf of a plan. In order to act prudently in making investment decisions, the trustees must consider, among other factors, the availability, risks and potential return of alternative investments for the plan. Investing plan assets in loans meeting these criteria would not satisfy section 404(a)(1) if such loans would provide the plan with less return, in comparison to risk, than comparable investments available to the plan or if such loans would involve a greater risk to the security of plan assets than other investments offering a similar return.

Thus, in deciding whether and to what extent to invest in mortgage loans, the trustees must consider only factors relating to the interests of the plan participants and beneficiaries in their retirement incomes. A decision to make a loan may not be influenced by a desire to stimulate business in a particular geographic area or to encourage the use of union labor unless the investment, when judged solely on the basis of its economic value, would be equal to or superior to alternative investments available to the plan.

D-7521

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Toledo Roofers Local No. 134 Pension Plan and Trust; Cement Masons Local No. 886/404 Pension Plan and Trust; Millwrights, Machinery Erectors & Pile Drivers Local 1393 Retirement Plan and Trust; Sheet Metal Workers Local No. 6 Pension Plan and Trust; Toledo Painters and Allied Trades Pension Plan and Trust; Toledo Plumbers & Pipefitters Pension Plan and Trust; and Toledo Plumbers & Pipefitters Retirement Plan and Trust (collectively, the Plans) Located in Toledo, Ohio

[Prohibited Transaction Exemption 93-16; Exemption Application Nos. D-8502, D-8588, D-8589, D-8591, D-8592, D-8594 and D-8595]

Exemption

The restrictions of section 406(a)(1)(D) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(D) of the Code, shall not apply to the making by certain banks in the northwestern Ohio area (the Banks) of residential mortgage or home construction loans (the loans) to individuals who are participants of the Plans and parties in interest with respect to such Plans (the Participants) pursuant to an arrangement in which the Plans will purchase certificates of deposit (CDs) from the Banks, provided that the following conditions are met:

(a) The Trust Company of Toledo, N.A. (the Trust Company), an investment manager which is independent of the Banks, the Plans' trustees, and their affiliates, acts on behalf of the Plans for the assets involved in the proposed purchases of CDs, pursuant to the terms of separate written investment management agreements with each of the Plans, to independently determine whether each Plan should make a particular CD purchase;

(b) Callister, Duncan & Nebraska, P.C. (CDN), an independent fiduciary for the Plans, determines on an annual basis that the relevant Plan fiduciaries have discharged their fiduciary duties to the Plans in accordance with the requirements of the Act with respect to any decisions made by the Plans to adopt, implement, or continue participation in the proposed arrangement involving the purchase of CDs by the Plans and the making of the Loans by the Banks to the Participants (the Loan Program), and suspends a Plan's involvement in the Loan Program if such a determination cannot be made;

(c) Such CD purchases by a Plan comply with the conditions of section 408(b)(4) of the Act in instances where the Bank is a fiduciary or other party in interest with respect to the Plan (see 29 CFR 2550.408b-4);

(d) Each CD purchased by a Plan has a maturity not to exceed 36 months from the date of issuance, and pays the maximum rate of interest provided by the Bank for CDs of the same size and maturity being purchased at the time of the transaction by any customer of the Bank who is not eligible to participate in the Loan Program;

(e) Each CD offered to the Plans pursuant to this exemption is sold by the Bank in transactions with unrelated parties in the ordinary course of its business with customers other than the Plans;

(f) The interest rates on all CDs purchased by the Plans under the Loan Program, and the total net rate of return to the Plans taking into consideration all expenses associated with the transaction, are at least comparable to, or better than, the interest rates and total net rate of return that could be obtained by the Plans on other fixed income investments of similar risk and term at the time of each CD purchase;

(g) Each Bank which sells CDs to the Plans under the Loan Program is a solvent financial institution, as determined by the Trust Company at least annually based on an analysis of all relevant information involving the Bank's financial status;

(h) The CDs purchased by a Plan from any one Bank participating in the Loan Program do not exceed 4.99% of the fair market value of the Plan's total assets at the time of the transaction;

(i) The CDs purchased by a Plan from all of the Banks participating in the Loan Program do not exceed 8.49% of the fair market value of the Plan's total assets at the time of the transaction;

(j) No Plan trustee, or other Plan fiduciary, who may be involved in any decision regarding a Plan's participatic in the Loan Program, received a Loan under the Loan Program;

(k) As of October 5, 1992, a Plan trustee involved in decisions regarding the Loan Program, or an entity in whic such Plan trustee has a 50% or more ownership interest, may not engage in any additional personal or business transactions with a Bank during a Plan participation in the Loan Program with such Bank, as attested to in each instance by appropriate Bank officials on an annual basis and monitored by CDN as the Plan's independent fiduciary;

(l) The investment of the Plans' asset by the Trust Company in CDs of a Bank which participates in the Loan Program is not part of an agreement, arrangemer or understanding designed to benefit th Trust Company; and

(m) In the event any Participant defaults on a Loan from a Bank, the Bank has no claim against, or recourse to, the CDs or any other assets of the Plans.

Temporary Nature of Exemption

The exemption will be effective only for those Loans made by the Banks to the Participants pursuant to the Loan Program within five years of the date of which this exemption is published in the Federal Register. However, the applicant may, if desired, apply for an extension of the exemption at the end o the five-year period. The application fo extension should describe: (i) Whether and how compliance with the exemption has been achieved; (ii) the number of transactions engaged in under the exemption; and (iii) the particular decisions made by the Plans' fiduciaries regarding the Loan Program.

For a more complete statement of the facts and representations supporting the Department's decision to grant this exemption, refer to the notice of proposed exemption (the Notice) published on October 5, 1992 at 57 FR 45828.

Notice to Interested Persons

The applicant represents that it was unable to notify interested persons within the time period specified in the Notice. However, copies of the Notice were mailed by first class mail to all the local unions and contributing employer for the Plans by November 11, 1992. In addition, the Notice was published in the November 13, 1992 issue of The Voice of the Building Trades, the offici newspaper of all the local unions affiliated with the Northwestern Ohio Building and Construction Trades

Council (the Council) and its constituent local unions. The Voice of the Building Trades is mailed to the homes of all members of all organizations affiliated with the Council and is made available at all union offices and halls, employer association offices, etc. The applicant states that all participants in the Plans received the Notice through the official newspaper by November 30, 1992. Interested persons were advised that they had until January 4, 1993 to comment on the Notice. The Department did not receive any written comments from such interested persons.

Written Comments

The applicant's representative submitted two written comments regarding condition (k) of the Notice. Condition (k) requires, in pertinent part, that as of October 5, 1992, the date of the publication of the Notice, a Plan trustee involved in decisions regarding the Loan Program (and certain entities owned by the trustee) may not engage in any additional personal or business transactions with a Bank during a Plan's participation in the Loan Program with such Bank.

By letter dated November 24, 1992, the applicant proposed that the Department consider a modification to condition (k) in order to allow a Plan trustee to engage in or continue personal or business transactions with a Bank that has offered a proposal to see a CD to the Plan. The modification proposed by the applicant would allow personal or business transactions between a Plan trustee and a Bank provided the Plan trustee would: "* * * make full disclosure of the business relationship * * * prior to the action being taken; recuse himself from the discussion and vote on the matter; not vote on the purchase; and not use the authority, control or responsibility the possessed as a trustee to affect the issue in any way."

The Department notes that condition (a) of the Notice requires that the Trust Company of Toledo, N.A., an investment manager which is independent of the Banks involved and the Plan trustees and their affiliates, act on behalf of the Plans for the assets involved in the proposed purchase of CDs to independently determine whether each Plan should make a particular CD purchase.

This understanding of the role of the Trust Company under the exemption is echoed in representations of the applicant summarized in the Notice. Paragraph 6 of the Notice states that the Trust Company, as the Plan's investment manager for the proposed CD purchases, will determine whether each Plan should make a particular CD purchase from any of the Banks. In the Department's view, the applicant's proposed modification is based upon a presumption that the Plan trustees would be directly involved in decisions regarding the purchase of a particular CD from a particular Bank. However, it has not been suggested, otherwise, in the applicant's comment that the role of the Trust Company should be changed from that described in the application. As a result, the Department believes that the proposed modification is inconsistent with the prior representations of the applicant and the Notice is proposed and is therefore rejected.

By letter dated January 5, 1993, the applicant requested an expression of confirmation by the Department of its interpretation of the language of condition (k). In that letter the applicant stated that "* * * it is our opinion that if the Plan trustees designate the Trust Company of Toledo (or another qualified entity) as independent investment manager and the independent investment manager makes all of the decisions regarding participation in the Program and the purchase of a CD or CDs from a Bank, then the Plan Trustee has not been involved in decisions regarding the Loan Program and is not bound by (condition) k."

The Department disagrees with the applicant's interpretation of condition (k) of the Notice. The duty of the Trust Company as described in the Notice is to act only as a CD investment manager within the guidelines set by the Plan trustees for the fixed income investment portfolio of the Plans. The Trust Company is not authorized to invest assets of the Plans other than in CDs. In this regard, as described in paragraph 6 of the Notice, among their duties with respect to the Loan Program, the Plan trustees will allocate a certain percentage of the Plan's assets to the Trust Company for CD investment; will monitor the Trust Company's purchases of CDs to ensure that such purchases are consistent with the Plan trustees' asset allocation and investment policy guidelines; will monitor the performance of the Trust Company; will determine whether fixed income investments of comparable risk and term other than CDs become attractive for the Plan; and will instruct the Trust Company to return the net proceeds of the Plan's redemption of the CDs to the Plan trustees who will reallocate the assets involved to other fixed income investments managed by other investment managers. It has not been suggested in the applicant's comment that the Trust Company will assume these duties of the Plan trustees or that it become investment manager for assets other than the CDs. Accordingly, it is the belief of the Department that the duties of the Plan trustees as represented by the applicant involve trustees in decisions with respect to Plans' participation in the Loan Program.

As stated in paragraph 4 of the Not condition (k) is designed to assure th the Plan trustees and certain related entities will not derive any financial benefit, such as banking services at a reduced cost or business or personal loans under more favorable condition than available to other customers of t Banks, as a result of a Plan's participation in the Loan Program. Therefore, for a Plan trustee to engag or continue personal or business transactions with a Bank involved in Loan Program, condition (k) requires that a Plan trustee must either: (1) Remove himself from any considerations or decisions made by Plan's trustees regarding the Plan's participation in the Loan Program wi the Bank is involved; or (ii) not engag in any additional transactions with t Bank during the Plan's participation the Loan Program with such Bank.

Therefore, the Department has determined upon review of the entire record to grant the exemption as proposed.

For Further Information Contact: M E.F. Williams of the Department, telephone (202) 219-8883. (This is no a toll-free number.)

93-16

D-8502, 8588-89, 8592, 8594-95

Toledo Roofers Local No. 134 Pension Plan and Trust; Cement Masons Local No. 888/404 Pension Plan and Trust; Millwrights, Machinery Erectors & Pile Drivers Local 1393 Retirement Plan and Trust; Sheet Metal Workers Local No. 6 Pension Plan and Trust; Toledo Painters and Allied Trades Pension Plan and Trust; Toledo Plumbers & Pipefitters Pension Plan and Trust; and Toledo Plumbers & Pipefitters Retirement Plan and Trust (collectively, the Plans).

Located in Toledo, Ohio

[Application Nos. D-8502, D-8588, D-8589, D-8591, D-8592, D-8594 and D-8595]

Proposed Exemption

The Department is considering granting an exemption under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR Part 2570, Subpart B (55 FR 32836, 32847, August 10, 1990). If the exemption is granted, the restrictions of section 406(a)(1)(D) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(D) of the Code, shall not apply to the making by certain banks in the northwestern Ohio area (the Banks) of residential mortgage or home construction loans (the Loans) to individuals who are participants of the Plans and parties in interest with respect to such Plans (the Participants) pursuant to an arrangement in which the Plans will purchase certificates of deposit (CDs) from the Banks, provided that the following conditions are met:

(a) The Trust Company of Toledo, N.A. (the Trust Company), an investment manager which is independent of the Banks, the Plans' trustees, and their affiliates, acts on behalf of the Plans for the assets involved in the proposed purchases of CDs, pursuant to the terms of separate written investment management agreements with each of the Plans, to independently determine whether each Plan should make a particular CD purchase;

(b) Callister, Duncan & Nebeker, P.C. (CDN), an independent fiduciary for the Plans, determines on an annual basis that the relevant Plan fiduciaries have discharged their fiduciary duties to the Plans in accordance with the requirements of the Act with respect to any decisions made by the Plans to adopt, implement, or continue participation in the proposed arrangement involving the purchase of CDs by the Plans and the making of the Loans by the Banks to the Participants (the Loan Program), and suspends a Plan's involvement in the Loan Program if such a determination cannot be made;

(c) Such CD purchases by a Plan comply with the conditions of section 408(b)(4) of the Act in instances where the Bank is a fiduciary or other party in interest with respect to the Plan (see 29 CFR 2550.408b-4);

(d) Each CD purchased by a Plan has a maturity not to exceed 36 months from the date of issuance, and pays the maximum rate of interest provided by the Bank for CDs of the same size and maturity being purchased at the time of the transaction by any customer of the Bank who is not eligible to participate in the Loan Program;

(e) Each CD offered to the Plans pursuant to this exemption is sold by the Banks in transactions with unrelated parties in the ordinary course of its business with customers other than the Plans;

(f) The interest rates on all CDs purchased by the Plans under the loan Program, and the total net rate of return to the Plans taking into consideration all expenses associated with the transaction, are at least comparable to, or better than, the interest rates and total net rate of return that could be obtained by the Plans on other fixed income investments of similar risk and term at the time of each CD purchase;

(g) Each Bank which sells CDs to the Plans under the Loan Program is a solvent financial institution, as determined by the Trust Company at least annually based on an analysis of all relevant information involving the Bank's financial status;

(h) The CDs purchased by a Plan from any one Bank participating in the Loan Program do not exceed 4.99% of the fair market value of the Plan's total assets at the time of the transaction;

(i) The CDs purchased by a Plan from all of the Banks participating in the Loan Program do not exceed 8.49% of the fair market value of the Plan's total assets at the time of the transaction;

(j) No Plan trustee, or other Plan fiduciary, who may be involved in any decision regarding a Plan's participation in the Loan Program, receives a Loan under the Loan Program;

(k) As of the date this notice of proposed exemption appears in the Federal Register, a Plan trustee involved in decisions regarding the Loan Program, or an entity in which such Plan trustee has a 50% or more ownership interest, may not engage in any additional personal or business transactions with a Bank during a Plan's participation in the Loan Program with such Bank, as attested to in each instance by appropriate Bank officials on an annual basis and monitored by CDN as the Plan's independent fiduciary;

(l) The investment of the Plans' assets by the Trust Company in CDs of a Bank which participates in the Loan Program is not part of an agreement, arrangement or understanding designed to benefit the Trust Company; and

(m) In the event any Participant defaults on a Loan from a Bank, the Bank has no claim against, or recourse to, the CDs or any other assets of the Plans.

Temporary Nature of Exemption

The exemption, if granted, will be effective only for those Loans made by the Banks to the Participants pursuant to the Loan Program within five years of the date on which the Final Grant of this proposed exemption is published in the Federal Register. However, the applicant may, if desired, apply for an extension of the exemption at the end of the five-year period. The application for extension should describe: (i) whether and how compliance with the exemption has been achieved; (ii) the number of transactions engaged in under the exemption; and (iii) the particular decisions made by the Plans' fiduciaries regarding the Loan Program.

Summary of Facts and Representations

1. The Plans are multiemployer, jointly-trusted, employee benefit plans established and maintained pursuant to collective bargaining agreements between several of the northwestern Ohio building and construction industry labor unions (together, the Unions) and employer associations (together, the Associations). The Plans, collectively, have a total of approximately 6290 participants and have assets totalling approximately $128 million.

2. The trustees of each of the Plans (collectively, the Trustees) are the named fiduciaries of the Plans. The Trustees appoint from time to time certain investment managers to handle investment decisions for portions of the assets of each of the Plans. These Plan assets, which are managed by such investment managers, include short-term and fixed income investments made pursuant to broad investment guidelines established by the Trustees. Such investments often include CDs issued by banks as well as other investments designed to meet certain liquidity needs of the Plans. Under the Loan Program, the Trustees of each Plan will appoint a single investment manager (i.e. the Trust Company) to manage specific purchases of CDs from the Banks, within the guidelines set by the Trustees for the fixed income investment portfolios of the Plans. The CDs will be purchased under an arrangement pursuant to which

the Banks will consider making the Loans to the Participants under the Loan Program.

The Banks that are currently interested in participating in the Loan Program are Mid-American National Bank and Trust Company (Mid-Am), Ohio Citizens Bank, Fifth Third Bank of Toledo, Huntington National Bank of Toledo, and Society Bank and Trust.

The applicant represents that some of the Banks are or may become parties in interest with respect to the Plans as a result of being a service provider or fiduciary for certain assets of the Plans.[4] However, none of the Banks will be a fiduciary for any assets of the Plans involved in the proposed CD investments. All decisions concerning such CD investments will be made by the Trust Company, a Plan fiduciary that is independent of the Banks (see Items 5 and 6 below). In addition, all relationships of the Trustees and their affiliates with the Banks will be monitored by CDN to avoid any potential conflicts of interests under the Act by the Trustees and their affiliates (see Items 7 and 8 below).

3. The Loans which the Banks will consider making to the Participants include an unlimited number of residential mortgage loans that are underwritten to meet the standards of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The Loans will have interest rates based on the market rates offered in the northwestern Ohio area but will be offered to the Participants with reduced or no closing costs. The Loans will also include a limited number of residential mortgage or home construction loans to Participants offering market interest rates, with reduced or no closing costs, which do not meet the standards of Fannie Mae or Freddie Mac. These Loans will not meet the Fannie Mae or Freddie Mac standards because, among other things, the Participant lacks enough cash for a down payment or because of technical rejections by the PMI insurance underwriter who underwrites the mortgage insurance for loans with less than a 20% down payment. All of the Loans will be made on a basis which is consistent with the general lending standards established by the Banks for similar loans and will be in compliance with applicable federal and state banking laws. The applicant states that in the event any Participant defaults on a Loan from a Bank, the Bank will have no claim against, or recourse to, the CDs or any other assets of the Plans.

4. The CDs will have a maturity not to exceed 36 months from the date of issuance. The CDs of the size and maturity purchased by the Plan will have terms identical to CDs which are offered and sold by the Banks to unrelated customers not participating in the Loan Program. Each CD purchased by a Plan will Pay the maximum rate of interest provided by the Bank for CDs of the size and maturity being purchased. The interest rates on the CDs will be at least comparable to, or better than, the interest rates that could be obtained by the Plans on fixed income investments of comparable security and term at the time of the transaction.

The CDs purchased by a Plan from any particular Bank participating in the Loan Program will not exceed 4.99% of the fair market value of the Plan's total assets at the time of the transaction. In addition, the CDs purchased by a Plan from all of the Banks participating in the Loan Program will not exceed 8.49% of the fair market value of the Plan's total assets at the time of the transaction.

No Trustee, or other Plan fiduciary, who may be involved in any decisions regarding a Plan's participation in the Loan Program, will receive a Loan under the Loan Program.[5] Moreover, no Trustee involved in decisions regarding a Plan's participation in the Loan Program, or an entity in which such Trustee has a 50% or more ownership interest, will engage in any additional transactions with a Bank during a Plan's participation in the Loan Program with such Bank. Therefore, the Trustees and related entities subject to their control will not derive any financial benefit, such as banking services at a reduced cost or business or personal loans from the Banks under more favorable terms than provided from other customers of the Banks, as a result of a Plan's participation in the Loan Program.

5. The Trustees will appoint the Trust Company to act as an investment manager on behalf of the Plans for the proposed purchases of CDs, pursuant to the terms of separate written investment management agreements with each of the Plans (the Investment Management Agreements). The Trust Company is a national bank chartered by the Comptroller of the Currency with authority to exercise fiduciary powers and is an investment manager, as defined in section 3(38) of the Act, with experience in handling trust investments for collectively bargained, jointly-trusteed employee benefit plans subject to the Act. The Trust Company is independent of the Trustees and their affiliates. The Trust Company will also remain independent of any Bank issuing CDs. There shall be no transactions between the Trust Company and the Banks which will interfere with the prudence or independence of the Trust Company to serve as the Plans' investment manager for CD purchases from such Banks.[7] The Trust Company acknowledges its duties, responsibilities and liabilities in acting as a fiduciary under the Act for the Plans. Theodore T. Hahn (Mr. Hahn), an Executive Vice President of the Trust Company, will be responsible for carrying out the duties of the Trust Company with respect to the Plans under the Investment Management Agreements. The applicant states that Mr. Hahn has extensive

[4] Section 408(b)(4) of the Act states, in pertinent part, that the prohibitions of section 406 of the Act shall not apply to the investment of a plan's assets in deposits which bear a reasonable interest rate in a bank supervised by the United States or a State, if such bank is a fiduciary of such plan and if such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or affiliate thereof) who is expressly empowered by the plan to so instruct the trustee with respect to such investment. Thus, a Plan's proposed purchase of CDs from a Bank that is a fiduciary or other party in interest with respect to the Plan would be exempt from the restrictions of section 406 by section 408(b)(4), if the conditions of the exemption, and the regulations thereunder (see 29 CFR 2550.408b-4), were met. However, the exemptive relief proposed herein would permit a Bank's making of Loans to certain parties in interest (i.e., the Participants) pursuant to an arrangement involving a Plan's purchase of CDs from the Banks. The Department notes that such an arrangement is a separate transaction which would not be exempted by section 408(b)(4) of the Act. The Department also notes that the proposed exemption is limited only to violations of section 406(a)(1)(D) of the Act which may result from the making of Loans to the Participants pursuant to the described arrangement.

[5] Section 406(b) of the Act states, in pertinent part, that a fiduciary with respect to a plan shall not deal with the assets of a plan in his own interest or for his own account and shall not receive any consideration for his personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

[7] The Department assumes, for purposes of the proposed exemption, that the investment of the Plans' assets by the Trust Company in CDs of a Bank will not be part of an agreement, arrangement or understanding designed to benefit the Trust Company. The Department recognizes that banks often price banking services based on a customer's total relationship to the bank. Thus, it is a common practice for a bank to treat some customers of the bank more favorably than other customers because of certain relationships (see Proposed Exemption for Relationship Banking for IRA and Keogh plan customers, 56 FR 8365, February 28, 1991). In this regard, the proposed exemption would permit the Participants to receive certain Loans from a Bank involved in the Loan Program pursuant to an arrangement whereby a Plan purchases CDs from the Bank. However, the Department notes that the relief provided by the proposed exemption does not extend to the receipt of consideration or benefits from a Bank, if any, as a result of a Plan's purchase of CDs from such Bank, by any Plan fiduciary, or to the receipt of any other consideration or benefits by a party in interest with respect to the Plan.

experience in managing fixed-income assets for employee benefit plans and has been recognized within the financial industry for providing superior fixed-income investment performance.

6. The Trust Company, as the Plans' investment manager for the proposed CD purchases, will determine whether each Plan should make a particular CD purchase from any of the Banks by reference to, among others, the following factors: (i) The asset allocations for the Plan; (ii) the investment policy guidelines of the Trustee; (iii) the financial conditions and creditworthiness of the Bank issuing the CD; (iv) the presence and extent of Federal Deposit Insurance Corporation (FDIC) protection for the Plan's CD; (v) the yield and liquidity of the CD as an investment in comparison to other fixed income investments of similar risk and term; and (vi) the expenses which the Plan will incur in connection with the transaction, including the payment of fees to CDN for its services as an independent fiduciary for the Plan (as discussed below in Item 8). In this regard, the Trust Company will ensure that the total net rate of return to the Plan from the CD, taking into consideration all expenses and fees associated with the transaction, will be at least comparable to, or better than, the rate of return available on other fixed income investments of similar risk and term at the time of the transaction. The Trust Company will also be responsible for decisions to suspend purchases of CDs by a Plan from a particular Bank based on these investment criteria.

The Trustees and the Trust Company have agreed, in writing as part of the Investment Management Agreements, to the specific percentage limitations on Plan assets that can be invested in CDs of a particular Bank (i.e. 4.99%) and in CDs of all of the Banks (i.e. 8.49%) under the Loan Program. In addition, the Trustees and the Trust Company have agreed that the purchase of any CDs by a Plan from the Banks when added to the Plan's other short-term or fixed income investments will not exceed the amount which the Trustees of the Plan have allocated for such investments. The Trustees of each Plan will monitor the Trust Company's purchases of CDs for the plan to ensure that such purchases are consistent with the Plan's asset allocation and investment policy guidelines.

With respect to the proposed investment by the Plans in CDs of a particular Bank, the Trust Company has initially determined that it would be prudent and consistent with the investment policies and objectives of the Plans, without taking into account any benefits which may accrue to the Participants under the Loan Program, to invest in CDs issued by Mid-Am in an amount up to the percentage limitations specified in the Investment Management Agreements. The Trust Company states that it will reconsider any investment decisions for CD purchases by the Plans from Mid-Am if the yields for CDs offered by the other Banks become more competitive or if other fixed income investments of comparable risk and term become more attractive for the Plans. The Trust Company will monitor interest rates on comparable CD investments after the Plan's proposed purchases of CDs from Mid-Am, or any other Bank, throughout the term of such CDs to ensure that holding the CDs until maturity would be in the best interests of the Plans, based on rates of return for comparable CD investments. If rates of return on comparable CD investments ever exceed the rate of return on a Plan's CD to such an extent that it would be economically advantageous to the Plan to redeem the CD prior to its maturity even if certain prepayment penalties are incurred, the Trust Company will redeem the CD, incur the prepayment penalties, and will reinvest the net proceeds in such comparable CD investments. However, the Trust Company is empowered to act only as a CD investment manager and is not authorized to invest assets of the Plans other than in CDs. In this regard, the trustees will monitor the performance of the Trust Company and will determine whether fixed income investments of comparable risk and term other than CDs become more attractive for the Plan. In such instances, the Trustees will instruct the Trust Company to return the net proceeds of the Plan's redemption of the CDs to the Trustees, who will reallocate the assets involved to other fixed income investments (such as U.S. Treasury Notes or Bills) managed by the Plan's other investment managers.[6]

7. The Trustees and the Trust Company have agreed to review at le annually the creditworthiness of any Bank issuing CDs to the Plans under t Loan Program. The Trustees and the Trust Company will contract the services of qualified, independent financial consultants to evaluate the financial conditions of such Banks on annual basis, which will be reviewed the Trust Company to determine whether the Banks are totally creditworthy and solvent lending institutions. The applicant states that the financial condition of Mid-Am an its affiliates is excellent based on a recent financial analysis by Houlihan Dorton, Jones, Nicolatus & Stuart, Inc an independent financial consultant i Salt Lake City, Utah.

The Trust Company's findings that purchases from the Banks would be prudent and consistent with the Plan: investment policies and objectives is based, in part, on the fact that, under current banking laws, each participa interest in the Plans will have FDIC protection up to a maximum of $100,(per participant.[6] The Trustees and th Trust Company will reconsider the purchase of CDs from the Banks if FI protection for the participants' intere in the Plans is ever reduced or jeopardized.

8. The Trustees have appointed CI a law firm in Salt Lake City, Utah, to as an independent fiduciary for the Plans pursuant to separate written agreements with each of the Plans. C represents that it is independent of tl Unions, the Associations, the Banks the Participants. CDN acknowledges duties, responsibilities and liabilities acting as a fiduciary under the Act fc the Plans. Jeffrey N. Clayton, Esq. (M. Clayton), an attorney with CDN who has had extensive experience with employee benefit plans, will be responsible for performing the independent fiduciary services for th Plans on behalf of CDN. The fees pai CDN for all services rendered in connection with its engagement to ac

[6] The Department notes that section 404(a)(1) of the Act requires, among other things, that a fiduciary of a plan must act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. In order to act prudently in making investment decisions, a plan fiduciary must consider, among other factors, the availability, risks and potential return of alternative investments for the plan. Investing plan assets in CDs would not be prudent if such CDs would provide the plan with less return, in comparison to risk, than comparable investments available to the plan or if such CDs would involve a greater risk to the security of plan assets than other investments offering a similar return. The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and benefits in their retirement income to unrelate objectives. Thus, in deciding whether and to wi extent to invest in CDs, a plan fiduciary must consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment in CDs of a particular bank may no influenced by non-economic factors, such as a desire to encourage the bank to make loans to participants, unless the CD investment, when judged solely on the basis of its economic valu would be equal to or superior to alternative investments available to the plan.

[6] See 12 CFR § 330.10 (1990).

an independent fiduciary will be paid by the Plans.

9. CDN represents that it will determine on an annual basis whether the Trustees have discharged their fiduciary responsibilities to the Plans in accordance with the Act in any decisions made by the Plans to adopt, implement, or continue participation in the Loan Program.[10] CDN will suspend a Plan's involvement in the Loan Program if a determination is made by CDN that the Plan's purchase of CDs from Mid-Am or any of the other Banks, pursuant to the proposed arrangement, would be inconsistent with the general fiduciary duties of the Trustees under the Act.

CDN has obtained information from the Union and Management Trustees of the Plans, Union co-sponsors of the Plans, Association co-sponsors of the Plans and employers affiliated with the Trustees, disclosing all transactions and relationships which exist between such persons or entities and Mid-Am. CDN states that it will obtain the same information regarding the relationships of such persons or entities to any of the other Banks prior to a determination made by CDN that the Trustees have met their fiduciary duties to the Plans concerning the proposed participation by the Plans in the Loan Program through the purchase of CDs from such Banks. CDN will monitor all relationships that the Trustees and their affiliates have with the Banks to ensure that a Plan's participation in the Loan Program will not result in a conflict of interest under the Act regarding the role such Plan fiduciaries may have in the implementation of the Loan Program.[11]

CDN notes that some of the Trustees and employers of the Trustees are involved in loan transactions with Mid-Am. However, CDN has obtained an affidavit from Phillip C. Clinard, a senior corporate officer at Mid-Am, which indicates that all such transactions and relationships are bona fide, arm's-length, and have no relationship to the proposed Loan Program.

The applicant states that no additional loan transactions or services, or renewals of existing loan transactions or services, will occur between a Bank and any of the Trustees involved in decisions regarding the Loan Program, or any entities in which such Trustees have a 50% or more ownership interest, during a Plan's participation in the Loan Program with such Bank. CDN will obtain affidavits annually from any Bank that participates in the Loan Program. The affidavits will describe all existing transactions between the Bank and the Trustees of a Plan, as well as entities controlled by such Trustees, and will disclose whether any new transactions have occurred. If such new transactions have occurred during a Plan's participation in the Loan Program, CDN will provide notice to the parties to discontinue the transactions and will suspend a Plan's involvement in the Loan Program if the transactions are not discontinued within a reasonable time.[12]

10. CDN represents that the Trustees have discharged their fiduciary responsibilities to the Plans in accordance with the Act in the proposed implementation of the Loan Program and that proceeding with the Loan Program will not constitute a violation of the Trustees' fiduciary duties under the Act. However, CDN states that two of the Trustees, Neil MacKinnon (Mr. MacKinnon) and Robert R. Good (Mr. Good), have relationships to Mid-Am which would create a conflict of interest if they are allowed to participate in any decisions by the Plans to implement or continue participation in the Loan Program regarding the purchase of CDs from Mid-Am. In this regard, CDN notes that Mr. MacKinnon is a Trustee of the Toledo Roofers Local No. 134 Pension Plan and Trust (the Toledo Roofers Plan) and is a director and shareholder of Bancsites, a formerly wholly owned real estate subsidiary of Mid-Am which has derived significant amounts of its revenue from Mid-Am in recent years. Mr. Good is a Trustee of the Sheet Metal Workers Local No. 6 Pension Plan and Trust (the Sheet Metal Workers Plan) and is a stockholder in Mid-Am and a member of the advisory board for one of Mid-Am's branch banks. CDN represents that its determination that the Trustees will meet their fiduciary duties under the Act with respect to the implementation of the Loan Program presumes the removal of Mr. MacKinnon and Mr. Good from any role in decisions concerning the participation of the Toledo Roofers Plan or the Sheet Metal Workers Plan in the Loan Program with respect to the purchase of CDs from Mid-Am. The applicant states that Mr. MacKinnon and Mr. Good have not been involved in any decisions concerning their Plans' proposed participation in the Loan Program. In addition, the applicant states that Mr. MacKinnon and Mr. Good, as well as any other Trustee which has or may have a conflict of interest with Mid-Am or any of the other Banks that may become involved in the Loan Program, will remove themselves from any considerations or decisions made by the Plans to adopt, implement, or continue participation in the Loan Program and will not use their influence upon any other Trustee regarding such decisions.

11. In summary, the applicant represents that the proposed transactions will satisfy the statutory criteria of section 408(a) of the Act and section 4975(c)(2) of the Code because: (a) The CDs purchased by the Plans will have the maximum rate of interest provided by the Bank for CDs of the size and maturity being purchased at the time of the transactions by any customer of the Bank not eligible to participate in the Loan Program, and will be at least comparable to, or better than, the interest rates that could be obtained by the Plans on fixed income investments of similar risk and term at the time of the transaction; (b) the CDs purchased by a Plan from the Banks participating in the Loan Program will not exceed 6.49% of the Plan's total assets at the time of the transaction; (c) no Trustee, or other Plan fiduciary involved in any decisions regarding a Plan's participation in the Loan Program, will receive a Loan under the Loan Program, and no Trustee or entity in which such Trustee has a 50% or more ownership interest will engage in any additional transactions with a Bank selling CDs to a Plan during a Plan's participation in the Loan Program; (d) the Banks will have no claim against, or recourse to, the CDs or any other assets of the Plans in the event of a default by

[10] The Department notes that CDN's representations pertain to the Trustees and their affiliates. The Department assumes the purposes of these representations that CDN will also perform the same functions with respect to any individual or entity which provides investment advice, within the meaning of 29 CFR 2510.3-21(c), to the Trustees regarding decisions to adopt, implement or continue participation in the Loan Program.

[11] The applicant states that the Northwestern Ohio Building and Construction Industry Foundation (the Foundation), a non-profit unincorporated association organized under the laws of Ohio which constitutes "plan assets" of some of the Plans, has participated in construction loans with certain lending institutions in the northwestern Ohio area, including Mid-Am. Pursuant to Prohibited Transaction Exemption 85-68 (PTE 85-68, 50 FR 31272, March 20, 1985), some of these construction loans have been made to parties in interest with respect to the Plans. The applicant represents that all transactions involving the Foundation and Mid-Am, as well as the other lending institutions, have met the conditions for relief under PTE 85-68.

[12] The Department notes that the proposed exemption, if granted, will not be available for any Loans from a Bank to Participants of a particular Plan pursuant to the described arrangement where any new transactions between that Plan's trustees, or entities controlled by such Trustees, and such Bank have occurred (see condition (h)).

a Participant on a Loan; (e) the Trust Company, as the Plans' independent investment manager for the proposed CD purchases, will determine whether each Plan should make a particular CD purchase from any of the Banks; and (f) CDN, a qualified, independent fiduciary acting for the Plans, will determine whether the relevant Plan fiduciaries have discharged their fiduciary responsibilities to the Plans with respect to any decisions made by the Plans to adopt, implement, or continue participation in the Loan Program and will suspend a Plan's involvement in the Loan Program in the event that such a determination cannot be made.

FOR FURTHER INFORMATION CONTACT: Mr. E.F. Williams of the Department at (202) 523-8883. (This is not a toll-free number.)

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and/or section 4975(c)(2) of the Code does not relieve a fidiciary or other party in interest of disqualified person from certain other provisions of the act and/or the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which among other things require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(b) of the act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) Before an exemption may be granted under section 408(a) of the Act and/or section 4975(c)(2) of the Code, the Department must find that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries and protective of the rights of participants and beneficiaries of the plan;

(3) The proposed exemptions, if granted, will be supplemental to, and not in derogation of, any other provisions of the Act and/or the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction; and

(4) The proposed exemptions, if granted, will be subject to the express condition that the material facts and representations contained in each application are true and complete, and that each application accurately describes all material terms of the transaction which is the subject of the exemption.

Signed at Washington, DC, this 30th day of September 1992.

Ivan Strasfeld,

Director of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor.

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ETIs: Performance and Fiduciary Duty

M. Wayne Marr
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We review the performance of public pension systems engaged in Economically Targeted Investments (ETIs) and describe the inherent risk involved with their selection.

PERFORMANCE

Ideally, we would like to have actual investment performance data of past and current "individual" ETIs. An analysis of the cash flows and administrative costs would allow for a better understanding of the investment characteristics of ETIs. At present, we know of no individual objective data for ETIs. The anecdotal evidence suggests that "successful" ETIs perform reasonable close to predicted benchmarks. However, most successful ETIs are backed by some type of insurance—either federal or state. The investment performance of unsuccessful ETIs is typically associated with negative returns. Many of the public pension funds that have operated ETIs have abandoned their ETI policy. The 1993 Study of ETIs by the Institute for Fiduciary Education reports that one third of the funds engaged in ETIs in the 1989 Study were no longer involved with ETIs by 1993.

To better understand the investment performance of ETIs we have analyzed three cross-sectional surveys of state and local public pension systems by the Public Pension Coordinating Council. Comparing the portfolio returns of the pension systems that use ETIs with the systems that do not use ETIs allows us to estimate the return contribution of ETIs to overall portfolio performance.

We find that pension funds engaging in ETIs underperform the non-ETI pensions by 110 to 320 basis points per year. In our latest research, which remains ongoing, some of the underperformance is from the difference in governance structure between different pension systems. In a public pension system, if the interests of the pension managers are not directly aligned with those of the taxpayer the conflict will cost the taxpayer in efficiency (which economists call agency costs). The pension systems that use ETIs are associated with the governance characteristics that predict high agency costs. However, our investigations to date show that pension funds with ETIs underperform non-ETIs funds by 118 to 210 basis points per year even after accounting for differences in governance structure and asset allocation.

FIDUCIARY DUTY

Consider the social restrictions imposed on many public pension funds in the 1980s (no investments in South Africa or Northern Ireland). (And we are not arguing the merit of this investment strategy.) Many individual investors in private pension funds (for example, our own pension fund (TIAA/CREF) continue to use social policies even after warnings that limiting their investment universe would lower returns and increase risk.

This is a personal decision. Why would some investors choose a sub-optimal investment policy? They must be receiving a "consumption value" for following a policy they think is right. The reduced returns are offset by the satisfaction of doing "the right thing."

Now consider ETIs. The potential consumption value is much higher for ETIs than for social policies because a local community is targeted. Pension fund managers do not get their name in the paper for minimizing the risk in their portfolio. But fund an ETI and you get to "cut the ribbon" to begin a new building and get your picture in the paper. The high consumption value of ETIs (for their sponsors) have the potential for investments to be selected on characteristics unrelated to risk and return, especially when only weak fiduciary standards exist.

An example of how consumption value to the pension manager can usurp financial characteristics can be found in the 1993 Institute for Fiduciary Education study. Of the 95 ETIs reported in the study, only 47 (49.5%) reported specific benchmarks for their ETI programs. The rest had no specific benchmark or failed to respond to the question. Of the 95 ETIs, 21 were too new to report financial returns. Of the 74 remaining funds, only 26 (35%) reported a return. It appears that pension fund managers must be selecting ETIs on criteria unrelated to financial performance and are not makingserious efforts to monitor their progress (which is costly). Both traditional and modern portfolio theory require knowledge of the expected return and risks of each investment.

For the investment policy dealing with South Africa and Northern Ireland, we saw individual investors selecting this policy through mutual funds and choices in Defined Contribution plans before the public push for some institutional investors (primarily Defined Benefit plans and University Endowment funds) to adopt the policy. In contrast, no mutual funds or other vehicles for individual investors have been created for an investment policy using ETIs.

We would venture an educated guess—few investors feel that the consumption value of ETIs is worth the concessions in return and risk when their own money is involved. To date, only fiduciaries have invested in ETIs to any extent. To protect beneficiaries and taxpayers alike, trustees of pension funds must be bound to strong fiduciary standards. They need to keep their eye on the ball and not be allowed to be distracted. The absence of strong fiduciary standards will allow pension trustees to maximize their consumption value of investments at the expense of financial performance. The cost of this expense will be born by retirees and taxpayers.

PRIVATE PENSION SYSTEMS

The incentives for the trustee of a corporate pension plan are much better aligned with the interests of the corporate owners than the alignment between the public trustee and the taxpayers. The government has guaranteed a basic level of retirement benefits and instilled strong fiduciary duties to pension fund beneficiaries (through ERISA) to protect employees from having the corporation raid their pension assets.

We do grant that there is some gaming by both sides (employees and the management) regarding private pension policy. There is also gaming going on between corporations and the PBGC in funding of pension funds with $40 billion in unfunded liabilities, corporations have been able to redirect money for pension assets to other uses. The gaming will only increase if 5% of these assets are mandated (or encouraged) for ETI investment or fiduciary standards are weakened.

CONCLUDING REMARKS

The Department of Labor has been encouraging private pension systems to invest in ETIs. A mandate (or strong-armed encouragement) for ETI investment is an unwise and unsound governmental policy.

Retirement income is exactly that; income from investments after someone retires. It should not be a current transfer system.

I will now answer any questions.

ANALYSIS OF ECONOMICALLY TARGETED INVESTMENTS: NOT THIS ETI!

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> The Work Group [on Pension Investments] concludes that many sound investments exist in areas not usually targeted by pension funds. In some cases, investing in projects which are of local or occupational interests to a pension fund's participants can create a primary benefit from competitive financial returns and a collateral benefit from the creation of jobs, wealth, and other local economic ripple effects. In some cases, these benefits are measurable. In others, they are not measurable but can reasonably be presumed.[1]

Has modern investment management theory, taught to thousands of students over the last twenty years, changed? A major underpinning of modern investment management theory is the concept of efficient capital markets. Economists agree widely that capital markets function well; therefore, when they run into cases where financial markets do not appear efficient, they do not throw away the efficient markets theory. Instead, they ask whether there is a missing ingredient in their economic model that suggests that market inefficiencies do exist.

A market inefficiency that is publicly discussed is economically targeted investments (ETIs). ETIs are dual-purpose investments with decisions made in the joint interests of society and of pension plan participants/beneficiaries.

In reaching its conclusions regarding ETIs, the Work Group assumes that the United States capital markets are significantly inefficient, yet it provides no evidence to support such a conclusion. Providing evidence is critical if financial engineers are to correct these inefficiencies or to fill these "capital gaps." Histor-

ically, for example, government regulation produced capital gaps, and substantial monetary rewards have been available to those who can successfully invent new financial instruments to fill capital gaps.[2]

Economists also have a simple standard for determining whether a new product (real or financial) adds to social welfare. We ask one simple question: "Are people willing to pay their own hard-earned money to buy the product?" We do not see financial institutions (like mutual funds or the members of the Work Group) investing voluntarily in ETIs, nor do we expect to see such behavior in the future. In sum, ETIs are better labeled as poor investment projects.[3]

The Department of Labor (DOL) is responsible for interpreting the Employee Retirement Income Security Act (ERISA) of 1974; ERISA governs all private pension plans and establishes fiduciary standards for investments. Because DOL interpretations become law (unless overturned by a federal court), ERISA plan sponsors must understand DOL's views regarding important fiduciary issues. Therefore, our review of the *Report* attempts to provide insight into possible upcoming DOL interpretations regarding ETIs.

BRIEF BACKGROUND

Economically targeted investments are defined, in the *Report*, as investments designed "to stimulate the economic development, growth or job creation for a specific region or subgroup of a broader population." These investments take the form of mortgage programs, construction loans for projects with union workers, venture capital, and bailout loans for in-state companies. Lately, ETIs have included projects such as loans for municipal golf course construction, loans to a sorority house, municipal bond credit enhancement, and others. The Clinton Administration is also considering the use of ETIs to help fund public infrastructure projects (see "Financing the Future: Report of the Commission to Promote Investment in America's Infrastructure" [1993]).

ETIs are currently being used by many public pension funds. Private corporate pension plans, covered under ERISA, have generally not participated in ETI programs, although some multi-employer union pension funds, also covered under ERISA, have been permitted by the DOL to invest in ETIs.

THE BULL CASE FOR ETIs

In a news release Jack Marco [1992] writes: "These results prove that Economically Targeted Investments (ETIs) are a prudent investment as well as a way for pension plans to support the industry of their employers and participants."

Given the study's limited data, lack of a rigorous testing methodology, and lack of any risk adjustment for returns, we are currently re-examining the conclusions reached in the Marco study. Yet the Work Group accepts the conclusions of the news release on face value, without subjecting the study to close scrutiny. The Work Group writes "targeted real estate funds has (sic) been superior to most non-targeted funds over the last five-ten years.".

ETI projects cannot get financing from private-sector investment sources because dual-purpose investments inherently lead to large conflict of interest (or agency costs). Public pension funds are legally vulnerable to dual-purpose investments. That vulnerability, however, comes out of a contracting imperfection: Most public pension benefits are defined-benefit plans. Benefits from such plans are liabilities of the plan sponsor; hence, defined-benefit public plan beneficiaries are creditors of the state or local government. No such vulnerability exists for corporate defined-contribution plans; therefore, you do not see defined-contribution plans funding dual-purpose investments. For example, the Work Group writes:

> The effort to identify an investment's collateral benefits subtly biases the investment manager to understate expected risks or overstate expected returns on investments which appear to produce such side benefits. The more compelling the collateral benefit, the greater the risk of bias in evaluating expected investment performance.

A NEW DOL INVESTMENT STANDARD

The DOL's current interpretation of a plan sponsor's fiduciary duty is as follows:

> The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, in deciding whether and to

> what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment may not be influenced by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan (Advisory Letter to James S. Ray [1988]).

This DOL interpretation is consistent with modern investment management theory; the Work Group, however, extends the existing interpretation into another realm, that is, when "externalities" accrue to plan participants. The Work Group leans toward recommending a new "modified rate-of-return" that is not consistent with modern investment management theory. The Work Group appears on the verge of changing a fundamental investment tenet.

The new interpretation would allow financial benefits other than the primary rate of return to be included in the investment decision process. Calculated externalities accruing to the plan participants could be added to the expected cash flow of the investment to determine whether an ETI meets the prevailing rate test. And, as we explain below, the proposed comparison with a benchmark return, if not done correctly, would seriously distort the capital markets.

MODIFIED RATE OF RETURN FOR ETIs

The Work Group suggests that the risk-adjusted rate of return plus the valuation of net externalities to society is a better investment measurement than the standard risk-adjusted rate of return used by thousands of investment managers. In theory, this measurement could be used, but not in practice; externalities are impossible to quantify.

Additionally, the Work Group would use this new measurement for ETIs but compare the "modified rate-of-return" to a "non-modified" risk-adjusted rate of return, called the prevailing rate. This is mathematically incorrect; we would be comparing apples to oranges. The new proposed "modified rate-of-return" calculation for ETIs is biased because the ETI return would be compared to benchmarks that do not include collateral benefits.

If we assume that all investments (on net) benefit society and produce externalities, the proposed new procedure would bias the nation's capital flow toward ETIs and cause a tremendous distortion in the capital markets. If the DOL adopts this new "modified rate-of-return" test, all investments including stocks, bonds, mortgage-backed securities, etc., would be forced to use the "modified rate-of-return." The prevailing rate test would no longer be a valid test against which to measure investments.

The DOL may be close to adopting a "modified rate-of-return" test. The *Report* states how the value of the externalities could be incorporated into a project's rate of return calculation. The "modified rate-of-return" for an investment equals

$$\sum_{i=1}^{n} \frac{\left(\begin{array}{c}\text{After-Tax Cash Flows} + \\ \text{Equivalent "Net" Value} \\ \text{of Externalities}\end{array}\right)}{(1+r)^i} ,$$

where the discount rate (r) solves the equation. The actual method of calculating the net value of externalities to the plan participants is not given. In fact, calculating net externalities would be difficult at best and in our view, impossible.[4]

THE WORKING GROUP'S CONCLUSIONS

In Section V of the *Report*, the Work Group presents its conclusions and recommendations.

Shortage of Long-Term Capital

> **Conclusion 1: The Work Group believes there is a shortage of long-term capital for programs which are broadly-viewed as economically and socially desirable. Pension funds could be an important source of financing, as long as the interests of participants and retirees are protected.**

The United States suffers from a shortage of long-term capital; the blame lies, however, with the ill-founded policies of the federal government, which currently runs a $300 billion+ deficit. This lack of controlled spending has crowded out private and public (state and local) investment capital over the last twenty years. The *Report*'s definition of "interests" of the participants is incorrect. The Work Group states that "collateral benefits to plan partici-

pants and beneficiaries may be one of the justifications" for using pension assets for socially desirable programs.

Let's be clear. Pension assets exist to fund individuals in their retirement years. This conclusion suggests allowing plan fiduciaries to invest in ETIs at below-market rates of return when externalities accrue to plan participants.

Allowing the Inclusion of Externalities

> Conclusion 2: The existing Department of Labor regulations on ETIs allow collateral benefits to be a secondary factor in pension trustees' investment decisions. If the Department were to allow fiduciaries to consider collateral benefits which accrue directly to plan beneficiaries in meeting the prevailing returns test, an indeterminate amount of additional funding might be allocated to ETIs.

An ETI with a risk-adjusted market rate of return is, by definition, not an ETI. ETIs simply do not exist as a separate asset class such as stocks, bonds, or mortgages.

When ETIs provide a below-market rate of return, the measurable externality could be added to the rate of return to boost the total investment benefit (or the modified risk-adjusted rate of return) to make the ETI appear to meet the prevailing rate test. As discussed earlier, a "modified risk-adjusted rate-of-return" is not practical to measure and if used, all investment returns would have to be calculated in a similar fashion.

Examples

Consider the case of a union pension plan investing in a construction project that employs only union workers but receives a below-market rate of return. If the project were not funded through other means, and the workers not likely to be employed, then union pension fund sponsors might argue that job creation for the union workers is a direct financial benefit to the plan participants.

This externality, however, does not accrue to retired beneficiaries of the plan or plan participants who are already employed on a different project. Therefore, active plan participants and retired beneficiaries value the externality differently. In addition, it is likely that employed versus unemployed union members would also value the externalities differently.

For defined-contribution pension plans, the participant typically decides how the assets are to be allocated by the fund chosen for the contributions Most plans of this type have, at a minimum, an equity fund, an income fund, and a cash or guaranteed investment contract option.

Suppose, however, that an ETI fund is available to the individual. The plan fiduciary of an ETI fund (we assume) could invest in ETI projects with below-market risk-adjusted rates of return if collateral benefit were available to plan participants. We suspect such an ETI fund would not be in existence very long or would have minimal contributions.

ETIs CAN BE IN PENSION PORTFOLIOS

> Conclusion 3: There is evidence that carefully-selected, skillfully structured investment portfolios can be created which meet both the targeting objectives which may be important to a plan's beneficiaries or its sponsor and the plan's fundamental need for a competitive return on investment.

The wording of this conclusion indicates the riskiness of ETIs. The phrase "carefully-selected, skillfully structured" implies that the majority of ETI investments do not or cannot meet these dual objectives.

SUCCESSFUL ETIs?

The *Report* focuses on five successful ETI programs.[5] Some of these programs, however, invest only in guaranteed investments of government agencies, such as the mortgage programs of the City of New York Retirement System. The System sells local mortgages to the federal government in exchange for government-backed mortgage securities. After the exchange the investment is no longer an ETI, but a traditional mortgage-backed security with known risk and return characteristics. In fact, former Comptroller of New York State Edward Regan agrees with us — these programs are not ETIs but are federal government programs with taxpayer guarantees.[6]

The few successful ETI programs that the Work Group lists hardly compensate for the massive losses suffered by most ETI programs or the subpar performance of many more programs.[7] In a 1983 study of in-state mortgage programs (ETIs) in thirty-one states done at the Federal Reserve Bank of Boston, Alicia Munnell (now Undersecretary of Treasury for Economic Policy) found that investment returns v

1.5% to 2% below appropriate benchmarks.

Another serious problem with ETIs (rarely pointed out by proponents) is the added vulnerability to regional or geographical recessions. A defined-benefit pension plan is susceptible to the weakness of the sponsor. Many plan sponsors have less ability to contribute to their pension plan during a recession. If the pension plan's investment income is highly correlated with the local economy, double jeopardy occurs. A prudent pension fiduciary diversifies assets in investments with low correlation to the factors that affect the sponsor economy. Although the Work Group mentions this problem, it subsequently ignores this large risk to pension plans.

THE WORKING GROUP'S RECOMMENDATIONS

> Recommendation 1: Prudential standards of pension funds evaluating investments in sectors of the economy experiencing capital gaps should not be lowered, but pensions should remain alert to new investment structures that meet those standards.

We agree. We also applaud the *Report*'s supporting statement:

> The primary purpose of pensions is providing retirement income. This goal cannot be sacrificed to other goals or to subsidize social change.

Unfortunately the *Report* continues:

> Pensions should also be encouraged to search for ways to lower the transaction and administrative costs of ETI projects.

A plan fiduciary does not have any responsibility to make ETIs work. That responsibility lies with the creator or the financial engineer of the investment. Plan beneficiaries do not benefit if plan fiduciaries use pension assets to "search" for ways to lower the administrative and monitoring costs of ETIs.

> Recommendation 2: The Department of Labor should take the initiative in gathering information about the investment performance and attributes of ETIs and making it available to the pension community to aid its investment decisions.

Given our review of ETIs, collection of these data would be worthless. If the data are valuable from an investment standpoint, the private sector will incur the cost to collect the data.

> Recommendation 3: DOL should preserve the current ERISA interpretation which allows pension plans to favor ETIs once such assets meet a prevailing rate test based strictly on their financial characteristics.

We agree. However, the Work Group continues by recommending the DOL establish procedures for pension trustees who invest in ETIs that would provide a "safe harbor." A safe harbor should not be provided for investments in ETIs. A safe harbor will set a precedent that ETIs are acceptable to the DOL.

> Recommendation 4: For ETIs that do not meet the existing prevailing rate test, the DOL should consider designing a "safe harbor" process for evaluating, benchmarking and tracking performance (incorporating the collateral benefits to current participants through the plan to achieve a prevailing rate) and specifying the plan structures for which such considerations may be suitable.

As stated earlier, a safe harbor should not be provided for investments in ETIs.

CONCLUSIONS

We agree with the Work Group's recommendation to allow pension fund trustees to invest in ETIs if and only if they meet the prevailing rate test (or the current interpretation of ERISA with respect to ETIs). But we disagree with the Work Group's recommendation to allow collateral benefits to be included in an ETI's performance analysis when comparing an investment's return to the prevailing rate. This is a dangerous softening of the ERISA fiduciary standards and increases the potential for abuse of pension assets. The DOL would also have to change to a "modified risk-adjusted rate-of-return test," which is not feasible.

The *Report* appears to be a blueprint for ETIs for private pension funds. ETIs do not belong in the portfolio of pension funds, especially as the baby boom generation is nearing retirement.

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ENDNOTES

[1] *The Report of the Work Group on Pension Investments, Advisory Council on Pension Welfare and Benefit Plans*, United States Department of Labor, November 1992 (hereafter called the *Report*). The Advisory Council advises the Secretary of Labor on key issues affecting employee welfare and benefit plans. Members of the Work Group were Edd Holder, Sandra J. Kinet, Edward R. Mackiewicz, Meredith A. Miller, Anne Moran, Maceo K. Sloan (vice chair), William H. Song, David M. Walker, and Ronald D. Wilson (chair).

[2] For example, Wayne Marr helped develop a successful financial instrument that was a regulation-induced financial product that filled a capital gap in the early 1980s — shelf-registered bonds and equity. In addition, Wayne Marr and John Trimble have written about other regulation-induced financial instruments that filled a capital gap — the Eurobond and Euroequity markets.

[3] There have been hundreds of new financial products over the last thirty years, such as swaps, swaptions, index futures, program trading, butterfly spreads, putable bonds, Eurobonds, shelf-registered bonds and equity, collateralized mortgage bonds, zero-coupon bonds, synthetic cash — to name just a few of the more exotic financial products. Interestingly, in all the finance literature, no one finds a new financial product called ETI. For more information on financial innovation and its causes see Miller [1992].

[4] The Work Group gives some explanation to the term "net" value. Externalities can be included only if there is reason to believe that the project would not get funding from sources other than the pension fund. If the project could get money from other sources, the local economy, and the plan participants, benefit without the pension fund forced to take a below-market rate investment.

[5] These are the City of New York Retirement System local mortgage program, the Connecticut mortgage program, Pennsylvania's investments in mortgages through a short-term liquidity fund, the AFL-CIO Housing Investment Trust and Building Investment Trust, and the CALLICO's ETI programs.

[6] Personal correspondence to Wayne Marr, April 25, 1993.

[7] See Marr, Nofsinger, and Trimble [1993] and Romano [1993]. Romano estimates (with econometric analysis) that her sample of public pension funds from 1985 through 1989 has lost a total of between $3 billion and $14 billion because of ETIs. The data provided do not make it possible to compute a percentage for any fund, but the evidence is consistent with the notion that most are below-market return investments.

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ECONOMICALLY TARGETED INVESTMENTS: A NEW THREAT TO PRIVATE PENSION FUNDS

by M. Wayne Marr, Clemson University, and John R. Nofsinger and John L. Trimble, Washington State University

Consider this: Over the next decade the U.S. will need more than $200 billion annually in new capital expenditure on infrastructure—on roads, bridges, airports, and so forth. However, the traditional sources of financing of public works, taxes and borrowing, will fall far short of these projected needs. The strain of outstanding debt limits state-and-local-government financing of new spending with tax-exempt public bonds to only about $35 billion annually. And, with the federal deficit at more than $300 billion for 1993 and deficit reduction a high priority, tax revenue and federal borrowing receipts will likely also fall far short of these needs. Further compounding the problem is a public mood against large tax increases. So where will the country get the funds so desperately needed for infrastructure investment?

This is the image conveyed in *Financing the Future*,[1] the report of the Commission to Promote Investment in America's Infrastructure. The Commission was created by Congress in 1991 to study the "feasibility and desirability of creating an infrastructure security" to permit pension funds to invest in public projects. It concludes that pension funds need to be more heavily involved in funding infrastructure through dual-purpose programs known as economically targeted investments, or ETIs.

But, for a bipartisan report with good ideas in some areas, *Financing the Future* is selective about the facts it presents, and curiously slanted in its view of pension funds. Much of America's infrastructure cries out for refurbishment, to be sure. But is the need to tap pension assets as great as suggested? Pension funds already invest in infrastructure where the cash flows and profit are sufficient to justify the risk.[2] And more traditional debt funding could be encouraged. The Tax Reform Act of 1986 imposes limits on tax-exempt public bonds. Yet those limits could be lifted to generate substantial additional funding capacity without harming the creditworthiness of states and municipalities, if Congress were convinced the cost to the federal treasury was justified.

And what about the "desirability" of tapping pension funds? On reading the report, it appears that the commission deemed its perceived need for infrastructure spending and the fact that pension funds have a lot of money as reason enough. Obviously, the $4 trillion pool of pension assets is a tempting target for a financially-strapped government: Imagine, if just 5% could be tapped, it would provide the $200 billion of infrastructure funding.

But the slanted point of view does not stop here. The commission's report goes on to criticize pension funds for "benefiting from tax deferrals" while failing to make their "fair share of infrastructure investment." Were pension funds ever meant to fund infrastructure? And weren't tax deferrals designed to encourage retirement saving? Where is the balancing concern for the income security of retirees? It does not exist in this report.

Instead, the report makes a questionable case for complex infrastructure securities that could be sold to pension funds. Why? Under federal pension-protection law, pension funds can invest in any project meeting the prevailing rate test: The 1974 Employee Retirement Income Security Act (ERISA) simply requires that an investment offer the prevailing rate of return commensurate with risk without threatening the fund's need for liquidity and diversification.

1. *Financing the Future: Report of the Commission to Promote Investment in America's Infrastructure*. U.S. Department of Transportation, Office of Economics, P-3, Washington, D.C. February 23, 1993.

2. Since pension funds are tax exempt, it is hard for them to justify municipal bonds offering tax-exempt rates, the traditional non-tax source of infrastructure financing.

Today, ETI proposals are being targeted to private pension funds. Yet ETIs seem to need preferential treatment to compete with alternative investments. If so, that puts them squarely in conflict with the federal pension-protection law, ERISA.

paid: Public funds are defined-benefit plans in which an employee's retirement benefit is determined according to a formula tied to final salary and years of service. Such benefits are liabilities of the plan sponsor. Hence, legally, defined-benefit-plan beneficiaries are creditors of the pension plan sponsor.

As a creditor, pension beneficiaries of public-employee plans could lose some or all of their retirement benefits if the plan sponsor—a city, county or state—goes bankrupt.[6] As a creditor, the retirement interests of pension beneficiaries of defined-benefit plans are thus legally linked with those of "society." They are not inherently linked by a compelling marriage of interests, as ETI advocates assert. For the legal linkage that exists under public plans would not exist if pension benefits were simply paid as a cash contribution each pay period, as they are in defined-contribution pension plans.

This is how the marriage-of-interests argument on which ETIs are based has gained legal foundation in the case of public-employee plans. It was vividly illustrated in 1975 in the case of New York City public-employee funds: In 1975, without the five major New York City public-employee pension funds' purchase of $2.53 billion of the City's bonds, New York City might have gone bankrupt with potentially calamitous consequences for those funds.[7] Thus, ETI advocates argue, there is a clear, inseparable marriage of interests between society and pension beneficiaries.

THE PRESENT DANGER OF ETIs

Today, as the work of the Commission illustrates, ETI proposals are being targeted to private pension funds. Private funds are crucial if ETIs are to be used to fund large-scale public projects. Yet ETIs seem to need preferential treatment to compete with alternative investments. If so, that puts them squarely in conflict with the federal pension-protection law, ERISA. Like any law, however, ERISA has weaknesses.

Complex financing schemes like infrastructure securities that potentially could disguise the likely poor profitability of ETI projects raise troubling questions. Why is there a need to be surreptitious? Why aren't ETIs being bought voluntarily? Why have ETI programs only been sold to those pension plans where participants cannot easily fire their pension-fund manager and hire a new one if ETI programs underperform. In choosing such a course, ETI proponents raise questions about their real aim: Are they trying to exploit weaknesses in the law governing trustee-beneficiary relationships to achieve a social goal at the expense of pension beneficiaries?

Trust relationships have in fact long been recognized under the law as inherently vulnerable to such exploitation. That's the reason for trust law. In the traditional trust, beneficiaries are dependent on the performance of the pension fund but have negligible control over the management of the assets. ERISA codified the common-law relationship between trustees and beneficiaries. It requires trustees to act with undivided loyalty to uphold the interests of the beneficiaries and to handle investments prudently, as men of prudence, discretion and intelligence manage their own affairs. By taking the dual-purpose course of explicitly pursuing public and private benefits, ETIs violate the fiduciary duty of exclusive loyalty. Diffusing this single-minded focus raises the specter, for professional investment managers, of diffusing prudence.

What are the dangers of diffusing prudence? If ETIs need government guarantees to pass the prevailing rate test of ERISA, then funding infrastructure and social needs on the scale described in *Financing the Future* would require mammoth new government guarantees. That's politically unlikely.

This brings us to the real danger: It is the deceptive consequences of allowing the larger legitimacy of ETIs to be debated on narrow legal issues related to public funds. As a result, the costs to pension beneficiaries of retirement resources not being used for their intended purpose are shunted aside.

A debate on the merits of ETIs should be focused primarily on the retirement-income interests of beneficiaries. That debate would take place by comparing performance in public funds with performance in self-directed, defined-contribution private pension plans—those in which the beneficiary's interest depends crucially on performance because contributions are made in cash and in which there

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[6] Private defined-benefit pension plans are insured by the Pension Benefit Guaranty Corporation, which was established under ERISA. Public-employee funds are not regulated by ERISA and, therefore, are not insured.

[7] See David L. Gregory, "Public Employee Pension Funds: A Cautionary Essay," *Labor law journal*, October 1980, pp. 703-705. Gregory also notes that the prudence of this investment was affirmed in New York courts.

Studies based on samples of public-employee pension funds nationwide show that funds with ETIs earned returns anywhere from 2 to 5 percentage points less than funds without ETIs. However, this evidence was not acknowledged in the commission's report, even though was clearly available to them.

based in Missouri. In 1990, after only three years and $5 million invested, the program was terminated. The program resulted in less than satisfactory investment returns and two lawsuits.[15]

Even programs held up as successful by ETI advocates are not very impressive. One such program is the $685 million Multi-Employer Property Trust, a fund financed by union pensions to invest in commercial construction projects built by union labor. The fund returned an annual rate of 5.6% for the five-year period ending September 30, 1992.[16]

THE FUTURE OF ETIs FOR PRIVATE PENSION FUNDS

What is the future of ETIs for private pension plans? It might appear based on the evidence we have presented that it is not good. That view, however, would be a miscalculation. For it fails to consider that the debate about ETIs has been conducted on public funds where legal issues can be exploited over economic ones.

The Administrator of Pension and Welfare Benefit Plans in the Department of Labor is the final arbiter of questions about compliance with ERISA. If the need arises and it is deemed legal, the Administrator can establish a procedure, called a safe harbor, for considering nonmonetary factors in investment decisions. Once done and promulgated as an official advisory letter, that procedure would become law unless or until changed in a court. And any pension trustee who followed the safe harbor procedure in an investment decision would be deemed by the Department, and likely by a court, to have acted prudently. Ironically, the outline of such a procedure was established in 1992 under the Bush administration.[17] Thus, legally, the Administrator could establish such a procedure tomorrow. That's how quickly the legal landscape could be altered to give a slight preference to public projects in the investment decisions of private pension trustees—and how quickly they could be pressured, perhaps ever so slightly at first, to invest in ETIs.

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15 Private communication, Missouri State Employees' Retirement System. In Joel Chernoff and Christine Philip, "Pension Funds Under Pressure," *Pensions & Investments*, February 25, 1993.

16 See *Economically Targeted Investments: An ERISA Policy Review* in footnote 8.

17 See *Economically Targeted Investments: An ERISA Policy Review* in footnote 8.

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STATEMENT OF JAMES Z. PUGASH
PRESIDENT, HEARTHSTONE ADVISORS
BEFORE THE
JOINT ECONOMIC COMMITTEE
MAY 18, 1995

INTRODUCTION

Good morning Mr. Chairman and members of the Committee. My name is James Pugash. I am President of Hearthstone Advisors. Hearthstone pioneered the concept of pension fund investment in single family homebuilding. The pension fund money we manage is used to finance the construction of single family homes for sale at a profit to middle class families. Hearthstone's investment portfolio includes nearly one billion dollars of commitments to 45 homebuilding projects. These projects will result in the construction of roughly 6,000 homes.

I should begin by confessing that I have a bias. I firmly believe that plan sponsors have a duty of undivided loyalty to their pension beneficiaries. This duty is inviolate and second to none. I also believe that it would be ludicrous to mandate that plan sponsors take social considerations into account when choosing among investment alternatives. Such a mandate would run contrary to the fundamental goal of ERISA.

At Hearthstone, we have only one objective - to earn as high a return as possible for our investors while avoiding unreasonable risk. To date, we have had some success. Our portfolio has averaged a return of over 20% per year. Of our 45 investments, our worst will break even and our best will yield over 50%.

Because of our track record, Hearthstone has been able to attract blue-chip

investors, including public and private pension plans, General Motors Acceptance Corporation, and the endowments of Stanford, Dartmouth, and MIT.

Most of our investors have no interest in targeted investing. Nonetheless, our investments do create jobs. They provide housing for the middle class, and they help communities grow. As a result, whether we like it or not, we frequently find ourselves in the middle of the debate over economically targeted investments.

THE WRONG QUESTION

In my opinion, much of this debate has centered on the wrong question. The right question is rarely posed.

People focus too much attention on the question whether targeted investments can generate acceptable risk-weighted returns. Of course they can.

Our company's track record of returns in excess of 20% per year surely proves this point. Homebuilding provides risk adjusted returns that are comparable or even superior to traditional pension fund real estate investments while adding substantial diversification benefits.

Others examples of sound investments that generate collateral benefits appear every day in the *Wall Street Journal.* FannieMae, for example, has been a stellar performer over the past decade. We would all be happy if every pension portfolio did as well as FannieMae stock over the past ten years. Yet FannieMae's charter requires that it help make housing more affordable for Americans. This is clearly a social objective.

I think it is fair to say the more successful the investment, the more likely it is to create jobs and stimulate the economy. Surely the debate over ETI's is about something more than this - otherwise it would have been settled a long time ago.

THE REAL QUESTION

The real question, in my opinion, is whether we can trust plan sponsors to

put their beneficiaries first if they are permitted to consider collateral benefits. Many people fear that political pressures, particularly on elected public fund trustees, can propel plan sponsors to engage in reckless social investing at the expense of their retirees.

These are legitimate concerns. But they should be put in perspective.

From what I have seen, most institutional investors are biased against anything that carries even a scent of social investing. I learned a long time ago that the surest way to lose a potential investor in Hearthstone's program was to talk about the social benefits from investing in homebuilding.

I have spoken with over 600 institutional investors, including public and corporate sponsors. Not one has asked me about the collateral benefits of our program. On the other hand, at least a dozen were unwilling to consider investing in homebuilding because they did not want to do something that they thought was socially motivated.

Federal law reinforces this natural bias against targeted investing a hundred-fold. ERISA and the Labor Department's regulations are clear that plan sponsors *in all cases* must give their beneficiaries undivided loyalty. As a corollary, they must give first priority to maximizing returns at any given level of risk. The penalties for failing to do so are severe.

Given these sanctions, fiduciaries will usually bend over backwards to avoid even the appearance of social investing.

THE LESSONS OF ORANGE COUNTY

In my view, the best way to assure that plan sponsors will place their beneficiaries first is (1) to impose this standard clearly in the law and (2) put mechanisms in place to hold plan sponsors strictly accountable to it.

I am a member of the Special Advisory Committee to the California State Senate on the Orange County Bankruptcy. Our job is to recommend legislation that will assure that another Orange County debacle does not happen. The lessons of

Orange County are appropriate to our discussion today.

Orange County did not go bankrupt because the Treasurer engaged in social investing. On the contrary, Robert Citron pursued profits with a single-minded zeal seldom seen in county officials. The problem in Orange County was that Robert Citron's strategy was reckless and he was accountable to no one.

California law does not set clear investment priorities for county officials. In addition, the Orange County Treasurer operated without adequate oversight or accountability.

The contrast with plan sponsors under ERISA could not be more striking. Pension fiduciaries are subject to strict investment standards that are set forth in federal statutes and administrative regulations. A variety of forms of oversight exist to make sure they adhere to these standards.

As long as these conditions exist I believe beneficiaries have little reason to fear that their fiduciaries will forsake them for social objectives.

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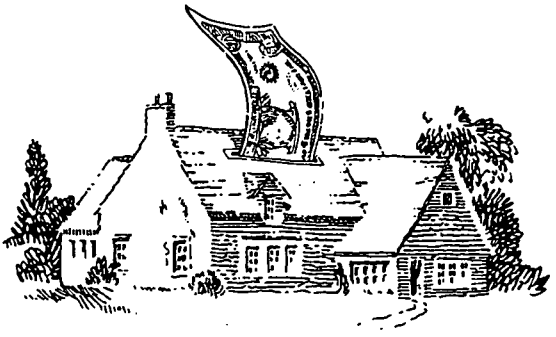
The Real Estate Institute of New York University WGL

Investments in single-family development yield high returns, hedge inflation, and diversify real estate assets.

Increasing Institutional Investments in Single-Family Home Building

James Z. Pugash



THE SUBJECT OF INVESTMENT in home building has recently received attention because of two significant trends. First, investment opportunities in home building have expanded dramatically because traditional sources of capital for home building—banks and savings and loan associations—have been forced by government regulation to withdraw from this segment of the market. Furthermore, traditional investment opportunities in commercial real estate development are limited or nonexistent in most regions of the country because of extensive overbuilding.

THE SUPERIORITY OF HOME BUILDING'S RISK-ADJUSTED RETURNS

Exhibit 1 compares the rates of return from the production of single-family homes with the returns of several other types of real estate investment. The exhibit indicates that during the past decade, single-family home building performed better than all other forms of real estate. Currently, single-family home building is the top-performing property type available. Readers should not be misled, however. In fairness to the other types of real estate, home building as reported in the exhibit represents a development activity, whereas the other measures of return are the results of passive investments. Home building is generally viewed as a highly risky and cyclical business; nevertheless, on a risk-adjusted basis, the returns in home building appear to more than compensate for the higher risk generally associated with real estate development.

Column 5 compares the risk-adjusted rate of return from home building with the risk-adjusted rates for alternative investments for the years 1980–1990. The data in Exhibit 1 implies that, even after taking into account the relatively high level of variability of home-building returns, sin-

James Z. Pugash is executive vice-president of Hearthstone Advisors.
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EXHIBIT 1

AVERAGE ANNUAL RETURNS AND RISK-ADJUSTED RETURNS OF SEVERAL TYPES OF REAL ESTATE INVESTMENTS*
1980–1990

Property Type	*(1) 11-Year Annual Return*	*(2) 3-Year Annual Return*	*(3) 1990 Annual Return*	*(4) 11-Year Standard Deviation*	*(5) 11-Year Risk-Adjusted Return*
Home building	19.9%	13.6%	12.3%	7.7%	1.44%
Offices	8.9	1.1	(2.8)	8.7	0.02
Retail	11.5	9.9	6.2	3.0	0.90
Warehouses	10.8	7.6	2.2	3.7	0.54
R & D Properties	11.7	4.1	1.5	7.6	0.37
Apartments	9.9	6.3	6.2	4.0	0.27
Russell NCREIF Index	9.7	4.7	1.2	5.2	0.17

* Source for all data, except the category home building: Russell NCREIF Index; MIG Realty Advisors, Inc.; Salomon Brothers. The returns on home building are those of four publicly traded homebuilders that built approximately 350,000 single-family homes during a period of 20 years. The rate of return represents the mean rate of return on an unleveraged basis of an investment in home building projects (as distinguished from an investment in a home-building company). The rates of return represent the total return from home building projects and do not allocate the returns between the builder and the capital. See "Rates of Return on Investment in Single Family Homebuilding," Hearthstone Advisors, 1991.

gle-family home building has produced the most attractive rate of return of any of the major real estate property types for the period from 1980 to 1990.

Risk-adjusted return assumes that the T-bill rate is the riskless rate. Thus, the actual rate minus the T-bill rate is the reward for taking risk. Risk over a period is represented by the standard deviation of the return time series. The extent to which the reward compensates the investor-developer for taking the risk is measured by comparing the reward with the risk (the standard deviation or variability of the return). Thus, the equation for column 5 is:

$$\text{Risk-adjusted return} = \frac{\text{Average return (col. 1)} - \text{average T-bill rate}}{\text{Standard deviation of average returns}}$$

HOME BUILDING AS AN INFLATION HEDGE

Investments in home building have historically produced rates of return that are significantly higher than increases in the consumer price level. The Hearthstone Advisors Index used in Exhibit 1 indicates that the average rate of return from home building was 19.9% over the 11 years 1980 through 1990, while the average annual increase in the Consumer Price Index was only 5.5%.

Surprisingly, the statistical correlation between home-building returns and inflation is negative. The correlation coefficient is −21%. This means that home-building returns tend to be higher in periods when inflation is lower. Inflation affects returns on home building in two ways. On the one hand, when inflation is high, home prices are rising and builders' profit margins tend to increase. But interest rates also rise when inflation is high, so that homes sell more slowly. Thus, even though profit margins are high, the slower pace of sales reduces the overall rate of return on investment.

Although the correlation between returns on home building and inflation is negative, the absolute value of the negative correlation coefficient is small, so the correlation between inflation and home-building returns is not strong.

HOME-BUILDING INVESTMENT DIVERSIFIES THE REAL ESTATE PORTFOLIO

Because home building is tied to a different sector of the economy than are other types of real estate, its returns are not very closely correlated with the returns of commercial and industrial real estate. Single-family home building, like development of multifamily housing, exposes the developer to housing sector risks. Most other forms of real estate development or investment expose the investor to the variables of the business economy (i.e., the variables of manufacturing, the service industries, and retailing). As a result, investment in home building can add diversification to the institutional real estate portfolio.

Exhibit 2 shows correlations of investment returns among various sections of the real estate industry for the period 1980 through 1990. Returns on investments in apartments and home building show the lowest cross-correlation with other types of real estate returns. For both apartments and home building, the cross-correla-

EXHIBIT 2
HISTORICAL CORRELATIONS AMONG REAL ESTATE SECTOR INVESTMENT RETURNS
1980–1990

	Office	*Retail*	*R & D*	*Warehouse*	*Apartments*[a]	*Home Building*
Office	100%					
Retail	34	100%				
R&D	77	39	100%			
Warehouse	74	54	58	100%		
Apartments	25	45	15	10	100%	
Home building	21	37	39	15	66	100%
Stocks	17	17	(9)	27	36	30
Bonds	(20)	(28)	(21)	(22)	25	2

[a] Correlation for 1988 to 1990 only for apartments.
SOURCES: Russell NCREIF, MIG Realty Advisors, Hearthstone Advisors, Ibbotson Associates

tion is strongest with retail properties, probably because the performance of residential and retail properties is linked to the strength of the consumer sector. The low correlations between home-building returns and office sector returns or warehouse returns means that adding home building to an institution's real estate portfolio should lower the level of overall risk in that portfolio.

OPTIMAL ALLOCATION OF THE REAL ESTATE PORTFOLIO

What proportion of its real estate portfolio should an institution invest in home building? Many institutional investors believe that the proportion of property types in a portfolio should reflect the relative proportion that property type represents in the aggregate market. Essentially, the investors attempt to match the universe of real estate holdings.

Exhibit 3 compares the proportion of institutional portfolios devoted to six real estate usage types with the proportion of each type in the aggregate market. Estimates of the total value of US real estate vary enormously,[1] but those in Exhibit 3 indicate that institutional investment in single-family home building is underweighted. Although single-family housing constitutes 51% of the total value of all real estate in the United States, pension funds have undertaken little direct investment in this property type, nor have other nonbank investors shown interest. Institutional investment in the single-family housing sector has been limited to ownership of securitized pools of mortgages collateralized by owner-occupied single-family homes. In addition, pension funds participated indirectly in home building as investors in banks and savings and loan associations, the two principal sources of financing for the home-building industry during the 1980s.

EXHIBIT 3
TOTAL VALUE OF US REAL ESTATE BY USE CATEGORY COMPARED TO DISTRIBUTION OF INSTITUTIONAL PORTFOLIOS

Category	*Total Value ($ trillions)*[a]	*Percent of Market*	*Percent of Institutional Portfolios*[b]
Single-family homes	$ 5.419	51%	0%
Apartments	.552	5.2	4
Retail	1.115	10.5	34
Office	1.009	9.5	42
Manufacturing	.308	2.9	6
Warehouse	.223	2.1	14
Total	$10.584	100%	100%

[a] Source: Arthur Andersen, "Managing the Future: Real Estate in the 1990's."
[b] Source: MIG Realty Advisors, Inc.—except for single family residences and home-building developments, which is assumed to be negligible.

Home building is estimated to be an $80 billion a year industry, making it one of the largest industries in the United States. The paucity of pension fund direct investment in this industry is striking.

Modern portfolio theory says that a portfolio is optimal when it offers the greatest return for the level of risk that the investor is willing to accept. Exhibit 4 shows three different portfolio mixes among various categories of real estate. Using the 11-year annual returns and the standard deviations of Exhibit 1, Exhibit 4 calculates an average return and standard deviation for each portfolio. Portfolio 1 does not include home building and shows the lowest historical return and the highest standard deviation. In contrast, portfolio

[1] See Meg Parker Holden, "The Nation's Portfolio of Institutional-Grade Real Estate," in this issue.

EXHIBIT 4

ALTERNATIVE PORTFOLIO MIXES

Category	*Portfolio 1*	*Portfolio 2*	*Portfolio 3*
Home building	0%	10%	20%
Office	35	30	25
Retail	25	25	20
R&D	10	5	5
Warehouse	15	15	15
Apartments	15	15	15
Historical Return	10.3%	11.2%	12.2%
Standard Deviation	4.7%	4.2%	4.1%

SOURCE: Russell NCREIF, MIG Realty Advisors, Hearthstone Advisors

3, which includes home building, shows a historical return that is 190 basis points higher than that of portfolio 1 with a standard deviation that is 60 basis points lower. The superior performance of portfolio 3 arises from including home building and stems from two factors: higher historical returns on home building and greater diversification.

CONCLUSION

Given the limited experience that institutional investors have had with home building, they probably will categorize home builders as a specialty-investment category during the next few years. Eventually, home building's ability to boost portfolio returns and provide diversity should make it a core holding of institutional real estate portfolios. ■

PREPARED STATEMENT OF EDWARD A. ZELINSKY

My name is Edward A. Zelinsky. I am a professor of law at the Benjamin N. Cardozo School of Law of Yeshiva University where, among other subjects, I teach and write about pension and welfare plans. In addition, I have served in several capacities relative to private and public pension plans. Today, however, I testify solely on my own behalf and do not appear for any plan or institution.

I speak against the concept which has come to be called "economically targeted investing" and to urge the adoption of Representative Saxton's bill, H.R. 1594, the Pension Protection Act of 1995. In the forthcoming issue of the Berkeley Journal of Employment and Labor Law, I criticize at length the notion of economically targeted investing and call for the revocation of Department of Labor Interpretative Bulletin 94-1 which approves such investing. Since the Department of Labor will apparently not repeal IB 94-1, Congress should.

The ETI concept is unsound as a matter of policy and logic and is incompatible with ERISA's statutory standards governing pension trustees' investment decisions. IB 94-1 defines economically targeted investments as deployments of capital which produce risk-adjusted market rates of return while also yielding collateral economic benefits. There is much paradox in the Labor Department's encouragement of market-rate investments: investments carrying competitive rates of return will, over reasonable periods of time, attract capital under normal market criteria; there is thus no need for particular solititude for ETIs. If such investments produce competitive returns, as we are told ETIs do, these investments will be undertaken by virtue of normal market forces; if, on the other hand, economically targeted investments are being shunned in the marketplace, that is a good indication these investments do not yield competitive returns.

Hence, the DOL's encouragement of ETIs is either superfluous, since the market would have made these investments anyway, or wrong, since the market indicates these investments should not be made.

Perhaps in anticipation of criticism along these lines, the proponents of ETIs and IB 94-1 argue that economically targeted investments are to be found in flawed markets. Such a defense of ETIs merely compounds the paradox: if proposed ETIs are located in seriously imperfect markets, pension trustees cannot be confident that such investments in fact yield competitive rates of return. Moreover, if serious market imperfections exist, the appropriate public policy is to address the imperfections directly, not to send pension trustees charging into poorly functioning markets.

Equally problematic is the confidence with which ETI proponents claim they can identify collateral economic benefits; indeed, many of the supplemental advantages claimed for ETIs can just as plausibly be found in more conventional investments. For example, ETI proponents frequently cite venture capital projects as yielding auxiliary economic benefits. There is much romance in this notion but no hard reason to conclude that new, start-up enterprises generate more positive externalities than less glamorous, more traditional deployments of pension capital.

There is, moreover, a significant danger that the highly subjective process of identifying externalities will degenerate into a brawl for the control of pension monies, a brawl in which the winner's victory will be rationalized in terms of collateral economic benefit.

Perhaps most importantly, IB 94-1 and its support of economically targeted investments are incompatible with the language and policy of ERISA. Statutorily and logically, ERISA's exclusive benefit rule is just that, a rule which proscribes pension trustees from considering any factors other than the interests of plan participants and their beneficiaries.

Rather than confront the inconsistency of IB 94-1 with ERISA's exclusive benefit rule and with the historic and policy considerations underlying that rule, ETI proponents contend that IB 94-1 merely codifies existing administrative interpretation of ERISA. As I demonstrate in detail in my forthcoming article, the administrative precedent cited for IB 94-1, when examined carefully, proves slender and unconvincing.

In light of all of this, it is tempting to dismiss IB 94-1 as destined for irrelevance. For three reasons, however, I conclude that IB 94-1, if allowed to remain on the books, is a serious matter.

First, IB 94-1 will, in particular cases, alter the dynamics of fiduciary decisionmaking and thus induce the deployment of pension assets away from conventional investments and toward ETIs. To the extent that such ETIs in practice carry competitive rates of return, the increase in ETI activity will be a charade since in reality market forces would have caused these investments to be made anyway. Insofar as investments labelled ETIs will in fact generate below market returns, such investments will potentially harm plan participants and their beneficiaries as well as shareholders and taxpayers.

Second, in the long run, we can anticipate that ETI proponents will press for mandatory ETI requirements since that is the direction in which their logic points: if ETIs produce significant collateral benefits while traditional investments do not, it is socially inefficient for pensions to make such traditional investments. While the current leadership of DOL

has characterized ETIs as optional for pension trustees, that is probably not the final position of ETI advocates.

Finally, IB 94-1 effectively reincarnates the discredited doctrine of industrial policy. In this privatized version of the industrial policy program, pension trustees are to fill the role previously assigned to government, guiding the society s allocation of capital with an acumen surpassing the wisdom of the market. Those of us who were skeptical of industrial policy in its first guise should be equally skeptical of its reappearance in the form of the economically targeted investment.

In some respects, the industrial policy character of IB 941 is its most troubling aspect for it reflects a disturbing tendency to eschew explicit taxation and expenditures in favor of implicit forms of taxation and spending. This tendency is of deep concern to all who believe that public policy should be implemented with maximum directness and accountability.

In short, IB 94-1, at best, misleads, suggesting that competitive investments need particular solicitude when in fact such investments will be undertaken by virtue of normal market forces. At worst, IB 94-1 opens the door to noncompetitive deployments of pension capital under the banner of economically targeted investing and encourages off-budget activism in an era when many policymakers perceive political and economic constraints as precluding more direct and open forms of governmental activity. In 1974, Congress, when it adopted ERISA's exclusive benefit rule, statutorily prohibited schemes like economically targeted investing. Congress's decision in this regard was right in 1974; it is right now. Congress should therefore enact the proposed legislation which would repudiate the notion of economically targeted investing.

I am also submitting to the Committee the text of my article on IB 94-1 and economically targeted investing. This article will appear in Volume 16 (July issue) of the *Berkeley Journal of Employment and Labor Law*. The article, subject to final revision before publication, may be reprinted and cited with appropriate credit to the *Berkeley Journal of Employment and Labor Law*.

ETI, Phone the Department of Labor:

Economically Targeted Investments, IB 94-1 and The Reincarnation of Industrial Policy

FINAL

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Introduction

On June 22, 1994, the Department of Labor (DOL) issued Interpretive Bulletin 94-1 (IB 94-1)[1], the Department's much anticipated statement on the propriety of pension[2] plans undertaking "economically targeted investments" (ETIs). Approximately two weeks earlier, the DOL had formally requested proposals for "a clearinghouse to collect and distribute information on" ETIs.[3] The DOL portrays IB 94-1 as simply a routine declaration of existing law and the ETI clearinghouse as merely a device to facilitate communications in the pension

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[1] 59 FR 32606, electronic citation: 94 tnt 121-24. IB 94-1 will be codified as 29 CFR section 2509.94-1. The DOL unveiled IB 94-1 at a hearing before the Joint Economic Committee on the day before the formal issuance of IB 94-1. See John Godfrey, "Prudent Pension Trustees May Use Social Goals To Pick Investments, Reich Says," 63 Tax Notes 1745 (June 27, 1994); Patricia A. Limbacher, "Funds get ETI go-ahead," 22 Pensions & Investments No. 13 (June 27, 1994) at 2. It is paradoxical that the DOL characterizes IB 94-1 as a routine declaration of existing law but elected to showcase IB 94-1 before a special congressional hearing. Not surprisingly, the testimony presented at this hearing was heavily weighted in support of IB 94-1. For the statement of an ETI opponent at this hearing, see testimony of William A. Niskanen, electronic citation: 94 tnt 121-34.

[2] The DOL pronouncement on ETIs applies, not merely to pension plans, but to all ERISA-regulated plans including profit sharing, welfare and 401(k) arrangements. For ease of exposition, I use the term "pension plans" to encompass all of these arrangements.

[3] Electronic citation: 94 tnt 115-37. In the fall of 1994, the DOL awarded the contract to implement the ETI clearinghouse. See Meegan M. Reilly, "Approved Bill Permits Ex-Participants to Sue Former Fiduciaries Regarding Purchase of Annuities," 65 Tax Notes 347 (October 17, 1994) at 348. In December, 1994, the DOL submitted a public information collection request to the Office of Management and Budget (OMB), seeking permission to gather information for the clearinghouse about plans' ETIs. See U.S. Department of Labor, Pension and Welfare Benefits Administration, Request for OMB Review and Supporting Statement (December, 1994).

industry.

A review of IB 94-1 and of the proposal for an ETI clearinghouse leads me to quite different conclusions. The ETI concept, as expounded by the DOL, is unsound as a matter of logic and policy and is incompatible with the statutory standards governing the investment decisions of pension fiduciaries. Moreover, the ETI concept, advertised by the DOL as a routine confirmation of existing law, reflects a more fundamental and unwise agenda: IB 94-1 and the ETI clearinghouse represent troubling steps in the reincarnation of the discredited theory of industrial policy.

The first section of this article discusses the DOL's definition of an ETI. The next section indicates how IB 94-1 makes the law of pension investments less coherent, less logical and less consonant with the relevant statutory standards. The third section of this article explores the current and potential harms stemming from IB 94-1. I close by concluding that the DOL should withdraw IB 94-1 or that Congress should repeal it.[4]

ETIs Defined

IB 94-1 defines ETIs as "investments selected for the economic benefits they confer on others apart from their investment return to the employee benefit plan." In its proposal

[4] See the Employee Benefit Plan Security and Protection Act of 1994, introduced by Congressman James Saxton, H.R. 5135, 103rd Cong., 2nd Sess. This legislation would have prevented pension trustees from considering collateral benefits in making their investment decisions and thus would have effectively repealled IB 94-1.

for an ETI clearinghouse, the DOL lists as typical ETI collateral benefits "new jobs, affordable housing (and) infrastructure projects." In the preamble to IB 94-1, the DOL identifies "real estate, venture capital and small business investments" as exemplars of potential ETIs.

An ETI, the DOL indicates, must generate a competitive return considering the investment's degree of risk. If an investment yields a market rate of return, controlling for risk, pension fiduciaries may then consider the investment's collateral economic benefits in deciding whether to make the investment. This conclusion, the DOL states, merely declares existing law under the Employee Retirement Income Security Act of 1974 (ERISA).[5] Indeed, the DOL has made IB 94-1 retroactive to January 1, 1975, ERISA's original effective date. Nothing noteworthy is occurring in IB 94-1, the DOL thus suggests; IB 94-1 simply pronounces current law ab initio.

To buttress its contention that IB 94-1 merely codifies existing fiduciary standards for pension investments, the DOL cites a number of administrative rulings and prohibited transactions exemptions it has previously issued under ERISA.[6]

While the current leadership of the DOL characterizes ETIs as optional for pension trustees,[7] that leadership has signalled

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[5] P.L. 93-406, 88 Stat. 894, 29 USC section 1001.

[6] See footnotes 2 through 7, inclusive, of the preamble to IB 94-1.

[7] Godfrey, supra, note 1 (noting DOL Secretary Reich's characterization of ETIs as optional for pension trustees).

its strong support for such investments: IB 94-1 and the proposed clearinghouse constitute a forceful official imprimatur for ETIs.[8]

The Unsoundness of the ETI Concept

For several reasons, the ETI concept is unsound as a matter of policy and logic and is incompatible with ERISA's statutory standards governing pension trustees' investment decisions.

Consider initially the DOL's definition of an ETI: an investment which carries a market rate of return, considering the associated risk, and which produces collateral economic benefits. Since ETIs yield competitive returns, adjusting for risk, the pension fiduciary may, according to the DOL, consider ETIs' supplementary advantages when making his investment choices without thereby violating ERISA's fiduciary standards.

The DOL's definition of an ETI is designed to avoid the pitfalls of earlier, cruder approaches to social investing by pension plans. Some of the initial advocates of social investing considered the attainment of market returns unimportant given the momentous causes for which they sought to use pension assets. In IB 94-1, the DOL disassociates itself from this more extreme

[8] See, also, Statement by Labor Secretary Robert B. Reich on Economically Targeted Investments by Six Pension Funds Working with the U.S. Department of Housing and Urban Development, USDL 94-381 (August 2, 1994) ("This Administration wants to encourage fund managers to consider investments such as these that help their beneficiaries and help the economy overall.")

approach.[9]

However, in doing so, the DOL creates a paradox for itself: by definition, an investment yielding a market rate of return is an investment which the market will clear without special consideration of the investment's ancillary benefits. One need not believe that markets operate perfectly, instantaneously or costlessly to believe that markets, over reasonable periods of time, will allocate capital to those ventures which can plausibly be expected to yield prevailing rates of return. If, as IB 94-1 indicates, ETIs generate competitive rates of return, there is no need for pension trustees or the DOL to extend particular solicitude toward those investments; they will be undertaken by someone because of normal market forces.

Instructive in this regard is the pro-ETI testimony of Dr. William Dale Crist, president of the Board of Administration of the California Public Employees' Retirement System (CalPERS).[10] Since CalPERS formally embraced an ETI policy in April of 1993, the fund has, pursuant to that policy, invested substantially in excess of a billion dollars of state pension monies in California

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[9] Robert Reich, "Labor Secretary Reich's Testimony at JEC Hearing on Targeted Pension Fund Investment," electronic cite: 94 tnt 121-28 ("ETIs are frequently confused with what is known as 'social investing.' In current parlance, this term usually refers to investment practices that subordinate financial return to some other social objective. The Department of Labor does not condone the use of pension funds in this manner. We prohibit it. ETIs are NOT social investing.") (capitalization in the original).

[10] electronic cite: 94 TNT 121-32. Dr. Crist's testimony was presented to the Joint Economic Committee at the hearing at which the DOL unveiled IB 94-1. See Godfrey, supra, note 1.

real estate ("single family housing construction, affordable housing mortgages, residential acquisition and development financing and commercial mortgages".)[11] In addition, CalPERs has, under the aegis of its ETI policy, invested $200 million of a planned $500 million in "investment opportunities that are intended to stimulate the California economy."[12] CalPERS also intends to invest resources in "private equity placements (that) offer the best long-term opportunity to deploy capital for job-creating projects on a large scale" and in funds and businesses owned "by minorities, women (and) California disabled veterans."[13] All of these deployments of state pension monies, Dr. Crist insists, generate competitive, risk-adjusted rates of return.

If that is so, CalPERS has accomplished nothing by its ETI program: if these investments carry market rates of return, the regular operation of the market would have resulted in these investments being made. And if these investments were being shunned by the market, that suggests that CalPERS is in reality embracing noncompetitive investments under the aegis of its ETI program.

Dr. Crist's optimistic analysis contrasts with Alicia H. Munnell's authoritative study of state pension plans' efforts to

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[11] Id.

[12] Id.

[13] Id.

encourage home ownership through their investment portfolios.[14] Much of these efforts consisted of plan purchases of mortgage-backed securities of the Government National Mortgage Association (GNMA). Such purchases were justified as increasing local supplies of mortgage capital. After careful study, Dr. Munnell concluded otherwise:

> "The roughly $14 billion of GNMAs purchased by state-administered pension plans has provided the pension funds with market returns. However, the 'Catch-22' phenomenon generally ascribed to social investing by its opponents seems applicable to this approach to supporting homeownership. Any housing investment that offers a competitive return at an appropriate level of risk, such as a GNMA, does not need special consideration from public pension plans nor will such consideration have any effect on the long-run supply of mortgage loans. On the other hand, investments by pension funds that will increase the supply of housing funds must by definition either produce lower returns or involve greater risk.[15]

Perhaps in anticipation of criticism along these lines, the DOL indicates that markets for ETIs are less active and less functional than the markets for other investments available to pension trustees. In particular, ETIs "may be less liquid and may not have as much readily available information on their risks and returns"[16] as other financial opportunities; ETIs may require

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[14] Alicia H. Munnell, "The Pitfalls of Social Investing: The Case of Public Pensions and Housing," New England Econ. Rev. (Sept./Oct. 1983) at 20.

[15] Id. at 36.

[16] See the preamble to IB 94-1.

greater than normal sophistication on the investor's part.[17] Hence, the need for particular solicitude for ETIs.

However, the association of ETIs with inefficient markets creates yet more paradox for ETI advocates. Well-functioning markets are necessary to ensure that returns are, as claimed, competitive. When a pension trustee invests in a poorly-functioning market, there is limited discipline and, consequently, a distinct possibility that returns are in fact below prevailing levels. If the markets in which ETIs are found are terribly flawed, pension trustees cannot be confident that such investments generate market rates of return.

There is, moreover, no reason to associate supplemental advantages with imperfect markets. No doubt, some investment markets are not as active and well functioning as others; certain investments require more investor knowledge than others. But there is no cause to equate these problems with the DOL's notion of collateral economic benefits. Indeed, if there is a correlation between collateral benefits and market imperfection, that correlation is likely to be negative. ETIs as defined by the DOL typically have important constituencies to merchandise them, i.e., the persons expecting to receive the investments' ancillary benefits. These constituencies have strong incentives to disseminate information about the investments from which they will profit. It is more likely that an ETI will be brought to

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[17] See also Crist, supra, note 10 (If not for CalPERS, ETIs "would have gone undiscovered in this very inefficient market".)

pension trustees' attention with supporting information than will an otherwise equivalent investment which lacks the advocacy of a collateral benefit constituency.

Finally, if important instances of market failure exist, the more compelling public policy is to correct that failure structurally rather than to inspire pension trustees to invest in flawed markets. If market failure is remedied, the entire universe of investors is attracted to the market, not just pension trustees.

In light of these considerations, the ETI clearinghouse is not merely an ambiguous proposal but an incoherent one. If the proposed clearinghouse is to be a marketplace for projects not now serviced by active markets, there is no reason to limit clearinghouse participation to pension plans: all investors with capital should be invited to partake of the new markets being established. If, on the other hand, the ETI clearinghouse is envisioned as something other than a marketplace, it is less desirable than creating such a marketplace.

To summarize: if markets are functioning, there is no need to assist ETIs by considering their collateral benefits since ETIs, as defined by the DOL, carry rates of return adequate to attract capital under normal market criteria. Absent the discipline of reasonably well-functioning markets, pension trustees cannot be confident that proposed ETIs carry competitive rates of return. If markets are not functioning, there is no reason to assume that the investments overlooked will be those

yielding ancillary benefits; those financial opportunities generating supplemental advantages are more, rather than less, likely to be identified and promoted by the groups anticipating those advantages. And the appropriate remedy for market failure is to correct the market.

In a curious way, the earlier doctrine of social investing, which largely eschewed concern for competitive returns on pension investments, was more coherent than the precept of economically targeted investing, which purports to accept the importance of markets and market-rate profits but ignores the implications of those considerations: investments generating competitive returns will generally be undertaken by market forces; in the absence of properly functioning markets, pension trustees cannot know with confidence that any particular investment does in fact generate market-rate earnings.

The foregoing analysis, like IB 94-1, assumes that collateral economic benefits can readily and objectively be identified, an assumption which, in many contexts, is highly questionable. The administrative letters and prohibited transactions exemptions cited by the DOL as examples of ETIs predominantly involve the building trades and yield, as auxiliary benefits, employment for construction workers. When, however, we venture beyond these simple cases, the identification of collateral benefits becomes more subjective and problematic. Indeed, beyond these easy cases, the supplemental advantages perceived in ETIs can just as plausibly be found in more

conventional investments and many proposals advanced by ETI proponents can reasonably be characterized as generating negative externalities.

Take, for example, venture capital projects, cited by the DOL in its proposal for the ETI clearinghouse as a category of investments potentially yielding auxiliary economic benefits. There is much romance in this notion but no hard reason to conclude that new, start-up enterprises generate more positive externalities than less glamorous, more traditional deployments of pension capital. When a pension plan purchases the existing stock of an established publicly-held corporation, the seller of that stock relocates his capital somewhere, possibly to the venture capital opportunity which was the pension plan's alternative investment choice. A strengthened price for its existing equity encourages the corporation to issue new stock for expansion with the attendant economic benefits of such expansion. A strenghtened price for existing stock also increases the net worth of other holders of that stock which, in turn, encourages their consumption and investment.

Or consider another case cited by the DOL as an ETI exemplar, affordable housing. Assuming we can agree what affordable housing is,[18] it is difficult to specify collateral

[18] For example, Connecticut law defines affordable housing with reference to the income levels of the families living in the particular locality in which the housing is located, not with reference to metropolitan-wide income levels. Thus, a project in an affluent Connecticut suburb is deemed "affordable" notwithstanding rents beyond the reach of most families in the metropolitan area as long as the project is relatively economical

benefits generated by such housing which cannot also be found in other, more conventional investments. Affordable housing projects can generate construction jobs but a pension plan also creates construction jobs when it makes a conventional deposit in a savings bank which the bank then uses to make mortgages. Affordable housing developments help the persons who live in them; however, those persons also benefit when a discount retailer offers consumer goods at lower prices or when the auto industry produces better and less expensive cars.

Again, the CalPERS experience is instructive. CalPERS defines its ETIs geographically, i.e., investments within the boundaries of California.[19] At first blush, this seems reasonable as geography is a credible basis for determining the existence of collateral benefits: externalities are plausibly found when activities are located in proximity to one another.

There are, however, negative effects to consider also: if other state pension plans emulate CalPERS and its geographic ETI policy, those states will similarly withdraw capital from other jurisdictions to invest at home; some of this capital will be removed from California. The resulting balkanization of the capital markets may on balance benefit California; at least as likely, California will, in the aggregate, lose capital in an

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by the standards of the prosperous suburb in which the project is located. See Conn. Gen. Stat. Ann. Section 8-39a. It would be particularly ironic if the DOL's encouragement of ETIs and affordable housing channels pension funds into the construction of housing too expensive for most Americans.

[19] See Crist, supra, at 10.

environment in which public pensions withdraw funds from other states to deploy them at home. At a minimum, it is distinctly possible that California's geographical ETI policy, by encouraging other states to repatriate their pension investments too, will yield negative externalities for California, i.e., less net capital for California investments as the California economy loses pension monies from other states' plans.

Moreover, such a ETI policy threatens unjustified underdiversification[20] for California pension plans as those plans withdraw their out-of-state capital and concentrate it

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[20] There are cases where a prudent fiduciary might reasonably sacrifice some diversification to further other legitimate objectives of his trust. For example, in recent years, trustees of many universities and colleges located in urban centers have quite sensibly invested portions of their endowments in the neighborhoods bordering their campuses. While such investments tend to concentrate schools' portfolios in communities in which the schools already have significant assets, i.e., the campuses themselves, such investments can stabilize the adjacent neighborhoods and thus make the campuses safer and more attractive places in which to learn, teach and research. In such instances, less geographical diversification is a price plausibly paid to further the college or university's educational mission.

Similarly, a pension trustee owning real estate might reasonably conclude that externalities justify the acquisition of an adjoining parcel to maximize the value of the pension's portfolio and thus advance the pension's mission of providing retirement benefits even though acquiring the parcel makes the pension's portfolio less diversified spatially.

In contrast, the geographic concentration caused by the CalPers ETI program is not designed to further the pension plan's basic duty, i.e., the provision of retirement benefits, but instead implements the pursuit of collateral economic benefits. In such a context, the decision to eschew diversification is much more troubling since that decision increases risk with no compensating advantage for the beneficiaries of the plan.

On the growing tendency of colleges and universities in urban areas to invest in adjacent neighborhoods, see Joseph N. Boyce, "Campus Movement," Wall St. J. (February 1, 1994), Section A, page 1, col. 1.

locally.[21]

ETI advocates seem quite prone to perceiving positive externalities in their proposals while overlooking such proposals' negative spillovers.[22]

In sum, if the concept of collateral benefit is defined so broadly as to encompass the externalities conceivably generated by traditional investments, the ETI category becomes meaningless as it incorporates the entire universe of traditional investments. If, however, the concept of collateral benefit is to be more carefully demarcated, ETI advocates must distinguish between the benefits yielded by ETIs and the benefits just as plausibly found in conventional investments. ETI advocates must also confront the negative effects of the policies they advocate. IB 94-1 does not attempt these burdens.

Another burden IB 94-1 avoids is to justify itself under the relevant statutory language. ERISA section 404(a)(1)(A)(i) requires pension fiduciaries to act "solely in the interest of the (plan's) participants and beneficiaries and...for the exclusive purpose of...providing benefits to participants and their beneficiaries..." This provision replicates the historic

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[21] As Judge Posner and Professor Langbein perceptively ask: "(S)uppose that a school board in the vicinity of Mount St. Helens had insisted on investing locally." John H. Langbein and Richard A. Posner, "Social Investing and the Law of Trusts," 79 Mich. L. Rev. 72 (1980) at 90.

[22] Consider, e.g., the willingness of Connecticut treasurer Francisco L. Borges to overlook the nature of the product manufacturered by Colt's Manufacturing Company: guns. See note 60, infra, and accompanying text.

"exclusive benefit" rule[23] upon which the Internal Revenue Code conditions pensions' tax-qualified status[24]; this ERISA provision also codifies the traditional requirement that fiduciaries act with undiminished loyally towards their beneficiaries.[25]

In several administrative rulings cited by the DOL on behalf of IB 94-1, the investments in question are construction projects and the collateral benefits at issue are jobs for plan participants. At first blush, it is a plausible interpretation of section 404(a)(1)(A)(i) that the "benefits" fiduciaries are charged with providing include not only plan distributions but current economic benefits as well, i.e., jobs. On a second look, however, James D. Hutchinson and Charles G. Cole persuasively argue that the "benefits" to which section 404(a)(1)(A)(i) refers are retirement, disability and death payments and not pre-

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[23] See Sections 401(a) (flush language) and 401(a)(2) of the Internal Revenue Code of 1986, as amended. The exclusive benefit rule also appears in the pension provisions of the Taft-Hartley Act. See Section 302(c)(5) of the Labor Management Relations Act of 1947, 29 USC Section 186(c)(5).

[24] Conventionally, the tax law's treatment of qualified plans is viewed as a tax expenditure. I disagree with this characterization, concluding that the Code's current approach to pension plans is consistent with normative tax principles. See Edward A. Zelinsky, "Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures, and the Flat, Plan Level Tax," 13 Va. Tax Rev. 591 (1994). For purposes of the present discussion, it is not necessary to resolve this issue but merely to observe that the Code establishes an exclusive benefit rule for qualified plans.

[25] John H. Langbein and Bruce A. Wolk, Pension and Employee Benefit Law (1990) at 517.

retirement economic advantages like employment.[26]

However, IB 94-1 defines ETIs even more broadly than this, as encompassing supplemental economic bounties for nonemployee constituencies, indeed for the economy as a whole. There is no warrant for this approach in the statute, which commands pension trustees to act solely and exclusively on behalf of participants and their beneficiaries.

There is case law under the Code version of the exclusive benefit rule which permits pension assets in practice to yield "incidental" advantages to persons other than employees and their beneficiaries.[27] If the exclusive benefit rule is to be applied by focusing upon the economic impact of pension investments (rather than upon the criteria utilized by pension trustees in their decisionmaking), such an approach is a practical necessity: when a pension trustee sells or buys an asset, the other party to the exchange profits or he would not be transacting with the trustee. Unless such inevitable third party benefit is overlooked, the exclusive benefit rule would preclude pension

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[26] James D. Hutchinson and Charles G. Cole, "Legal Standards Governing Investment of Pension Assets for Social and Political Goals," 128 U. Penn. L. Rev. 1340 (1980) at 1370 ("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 more narrowly throughout the Act to refer to those cash benefits that a participant or his family would receive in accordance with the specifications of the plan.")

[27] See, e.g., Shelby U.S. Distributors, Inc. v. Commissioner, 71 T.C. 874 (1979) at 885 ("the investments of a trust may result in some benefit to another person without the trust losing its exemption" under the Code's exclusive benefit rule.)

trustees from undertaking any investments at all. Moreover, as Professors Langbein and Fischel point out[28] in the context of defined benefit plans and the exclusive benefit rule, employers gain from their pensions' superior investment performance since such performance reduces the employers' funding obligations to their plans.

It is, however, a troubling leap from recognizing that in practice pension investments unavoidably entail incidental benefits of these sorts to embracing such incidental economic benefits as legitimate criteria upon which pension trustees can base their investment choices. As a normative statement of the concerns which pension trustees ought consider in making their investment decisions, a single-minded concern for the welfare of participants and beneficiaries is both a compelling standard as a matter of policy and the standard embodied in the statute.

Historically, the great challenge of fiduciary law has been to permit beneficiaries to profit from the skill, efficiencies and expertise of fiduciaries without permitting fiduciaries to abuse their positions of trust. The agency problems[29] inherent in fiduciary relationships are compounded in the pension context by

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[28] Daniel Fischel and John H. Langbein, "ERISA's Fundamental Contradiction: The Exclusive Benefit Rule", 55 U. Chi. L. Rev. 1105 (1988).

[29] On agency problems more generally, see Edward A. Zelinsky, "James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions," 102 Yale L. J. 1165 (1993) at 1173; Edward A. Zelinsky, "Unfunded Mandates, Hidden Taxation, and the Tenth Amendment: On Public Choice, Public Interest, and Public Services," 46 Vand. L. Rev. 1355 (1993) at 1374.

both beneficiaries' collective action problems, namely the costs and complications of beneficiaries banding together to protect their interests,[30] and the evidentiary difficulties of sorting out ex post the frequently complex financial transactions of large institutions. It was logical and appropriate for the drafters of ERISA to address these problems, inter alia, through fiduciary law's traditional duty of loyalty, the mandate that fiduciaries serve exclusively the interests of their principals and not pursue (or even contemplate) extraneous objectives. This very high standard of behavior is designed to deter pension trustees from even thinking about considerations other than participants' welfare and to facilitate retrospective review of fiduciary decisionmaking: even minimal evidence that something other than participant welfare has motivated trustee behavior triggers the protections of the standard. The exacting demands of the duty of loyalty insulate the fiduciary decisionmaking process from forces and factors with the potential of diverting that process from the welfare of the fiduciary's beneficiaries.

Consider in this context the comments of Olena Berg, assistant secretary for the DOL's Pension and Welfare Benefits Administration and the administrator who actually promulgated IB 94-1:

"Nothing in ERISA prevents the making of

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[30] When employees are unionized, the union's existence will sometimes solve their collective action problems for them. When, however, the union and its personnel are the difficulty rather than the solution, employees in their capacities as pension participants will often find it difficult and costly to organize themselves to protect their pension interests.

> (ETI) investments, provided that they meet the law's fiduciary requirements. Existing Department of Labor policies on economically targeted investments allow collateral benefits to be considered in making investment decisions where such investments are prudent and provide a competitive risk-adjusted return. I want to reaffirm that it is appropriate for plan fiduciaries to make economically targeted investments consistent with ERISA's prudence and exclusive benefit rules."[31]

Both as a statutory matter and as a matter of logic, this statement is a muddle: in making their investment decisions, pension trustees can consider supplemental benefits to nonemployee constituencies as long as the trustees comply with the exclusive benefit rule. But, statutorily and logically, the exclusive benefit rule is just that, a rule which proscribes trustees from considering any factors other than the interests of plan participants and their beneficiaries so as to insulate them from extraneous pressures and temptations. Rather than confronting the inconvenient language of the statute and the essential incoherence of her position, Secretary Berg contends that she is merely reaffirming the DOL's existing construction of the statute.

However, a review of the administrative pronouncements invoked by the DOL on behalf of IB 94-1 belies any contention that IB 94-1 is the codification of well-established or convincing administrative precedent.

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[31] Olena Berg, "A PW Exclusive: PWBA's Olena Berg Discusses Agency's Future," 29 Pension World No. 11 (November, 1993) at 16.

In support of IB 94-1, the DOL summons[32] seven exemptions it has issued under the prohibited transactions provisions of the Code and ERISA.[33] However, citing these prohibited transactions exemptions (PTEs) on behalf of IB 94-1 is, at best, unpersuasive and, at worst, disingenuous. The DOL issued each of the seven PTEs with the explicit caveat that the Department was not approving the exempted transaction under ERISA's fiduciary standards or under the Code's exclusive benefit rule but was only suspending the more limited operation of the prohibited

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[32] See footnote 3 to the preamble to IB 94-1. In its public information collection request to OMB, the DOL again invoked its prohibited transactions exemptions as administrative precedent for the approval of ETIs. See U.S. Department of Labor, supra, note 3 at page 1 of the supporting statement ("[T]he Department has granted a variety of prohibited transactions exemptions involving investments that produce collateral benefits.")

[33] These statutory provisions proscribe particular types of transactions (e.g., sales and exchanges) between plans and insiders positioned to abuse the assets of such plans (e.g., plan trustees, employers, family members of trustees and employers). Like much of the statutory framework governing employee plans, there are parallel versions of the prohibited transactions rules, one in the Internal Revenue Code and one in the labor provisions of ERISA. Administrative exemptions may be granted for specific transactions which would otherwise be precluded by statute. In 1978, President Carter delegated to the DOL authority to issue such administrative exemptions on behalf of the IRS.

For the text of the prohibited transactions rules, see Code Section 4975 and ERISA Section 406. For the 1978 delegation to the DOL of responsibility for administrative exemptions, see sections 102 and 105 of Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47,713 (1978), 1978 U.S.C.C.A.N. 9814. For additional background on the prohibited transactions rules, see Edward A. Zelinsky, "Pensions and Property Contributions: Wood, Keystone, and the Supreme Court," 56 Tax Notes 651 (August 3, 1992) at 652; Edward A. Zelinsky, "Property Contributions to Qualified Plans: The DOL Threatens Established Tax Law," 62 Tax Notes 753 (February 7, 1994) at 754.

transactions provisions. For example, PTE 76-1,[34] invoked by the DOL in support of IB 94-1, states that its exemption does not apply to the exclusive benefit rule of ERISA section 404 or of Code section 401(a). Each of the other PTEs cited by the DOL in the preamble to IB 94-1 contains the same or a similar qualification, indicating that the exemption pertains only to the prohibited transactions provisions and not to the other fiduciary standards governing pension trusts.[35] Hence, the seven PTEs do not support the proposition that ERISA section 404 permits pension trustees to consider collateral benefits.

In support of its claim of prior administrative interpretation, the DOL also cites[36] three official advisory opinions it has issued pursuant to ERISA Procedure 76-1,[37] the Department's formal process for declaring its views on ERISA issues. Two of these three advisory opinions, 88-16A[38] and 80-33A[39], pertain to the same practice, an agreement under which Chrysler and the UAW recommend to the institutional fiduciary of

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[34] 1976-1 C.B. 357, 41 Fed. Reg. 12740 (March 26, 1976), 1976 IRB Lexis 757. PTE 76-1 was issued jointly by the DOL and the IRS since it predated Reorganization Plan No. 4 of 1978 which shifted to the DOL exclusive jurisdiction over prohibited transactions exemptions. See note 33, supra.

[35] See, e.g., PTE 85-58, 50 Fed. Reg. 11272, cited in footnote 3 of the preamble to IB 94-1.

[36] See footnotes 2, 4 and 7 of the preamble to IB 94-1.

[37] 41 Fed. Reg. 36281 (August 27, 1976).

[38] 1988 ERISA Lexis 16.

[39] 1980 ERISA Lexis 45.

the Chrysler pension plan what are now being labelled ETIs. However, for two reasons, 88-16A and 80-33A provide, at most, limited support for IB 94-1 and its construction of ERISA section 404 as permitting pension trustees to consider collateral economic benefits. First, the DOL carefully noted in its analysis of the Chrysler-UAW arrangement that the DOL condoned only the process of recommending ETIs to the institutional fiduciary and that the DOL was not "expressing an opinion concerning whether specific transactions undertaken in accordance with the"[40] Chrysler-UAW recommendations satisfy ERISA's fiduciary standards. Second, in declaring that pension trustees must "ordinarily" concern themselves with the retirement income interests of participants and beneficiaries, advisory opinion 88-16A provides no reasoning or authority for thus diluting the statutory mandate that trustees consider such interests "solely" and "exclusively."

Similarly, DOL advisory opinion 85-36A,[41] cited in support of IB 94-1, provides no authority or reasoning for its conclusion that participant welfare is "ordinarily" to guide fiduciary investment decisionmaking or for its conspicuous disregard of the statutory requirement that such welfare be the sole and exclusive concern in such decisionmaking.

Finally, to support its claim that IB 94-1 reflects prior administrative interpretation of ERISA section 404, the DOL

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[40] See DOL advisory opinion 88-16A, 1988 ERISA Lexis 16.

[41] 1985 ERISA Lexis 8.

invokes a number of private letters which it has issued.[42] However, none of these was promulgated through the DOL's formal process for interpretting ERISA, ERISA procedure 76-1.[43]

Interestingly, the DOL ignores one relevant, albeit informal, declaration of past policy, Ian D. Lanoff's statement on social investing made when he was administrator of the DOL's Office of Pension and Welfare Benefit Programs.[44] That statement supports the contention that the DOL has in the past permitted pension fiduciaries to consider the incidental economic benefits of proposed investments if such investments otherwise pass muster.[45] On the other hand, a retrospective review of that statement and the context in which it was made point to a more complex conclusion, i.e., that, with the social investing movement gathering momentum, permitting pension trustees to consider otherwise acceptable investments' collateral benefits was a short-term stopgap adopted to protect for the long-run ERISA's fiduciary duties.

When Mr. Lanoff served as the DOL's chief pension administrator, it was decidedly possible that ERISA's fiduciary

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[42] See footnes 2, 4, 5, 6 and 7 of the preamble to IB 94-1.

[43] This is analogous to the IRS buttressing a claim of established administrative interpretation by citing private letter rulings.

[44] Ian D. Lanoff, "The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully under ERISA?" 31 Labor L. J. 387 (July, 1980). This version of Mr. Lanoff's statement was derived from testimony he had previously given a subcommittee of the U.S. Senate. See id. at 389.

[45] See id. at 392.

provisions would die stillborn, overwhelmed by the growing social investing movement. Many social investing advocates were calling for the deployment of pension funds to advance various political, social and economic causes without regard for ERISA and its exclusive benefit rule[46]; many of these causes were politically popular and morally compelling; ERISA itself was in its infancy and not widely understood; the courts had not yet created the body of case law which today reinforces ERISA's requirements of prudence and loyalty; an ERISA bar, conversant with those requirements and possessing an economic interest in enforcing them, had not yet developed. In this context, Mr. Lanoff quite accurately understood that the social investing movement threatened to render section 404 a dead letter before section 404 could be institutionalized.[47]

Hence, the position crafted by Mr. Lanoff -- incidental benefits may be considered if investments are otherwise satisfactory -- while not totally congruent with ERISA's exclusive benefit rule, was tactically astute in 1980 as an attempt to divert some of the pressure for social investing while preserving intact the core of ERISA's fiduciary duties.

Today, however, is not then. Many of the original advocates of social investing have over the years reexamined their

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[46] See, e.g., Reich, infra, note 64 at 244 (calling for the investment of pension funds "in regional development banks," which would help "spur the economy and thereby benefit American workers over the long term.")

[47] Lanoff, supra, note 44 at 389.

posture.[48] ERISA's fiduciary norms have been strongly reinforced by the courts and by the DOL's enforcement efforts. In academic debate, the center of gravity has shifted from discussion of social investing to the fiduciary protection of pension funds.[49]

In short, with the benefit of hindsight, the Lanoff position was a successful effort to buy time for the implementation of ERISA, an effort for which Mr. Lanoff deserves important credit. However, in 1994, we can see that that position, despite its valuable service in another time and another context, is not true to the terminology of the pension statute or its underlying logic.

In sum, the administrative precedent cited by the DOL for IB 94-1 is slender. To the extent those pronouncements do support IB 94-1, they too cannot be reconciled with the language of ERISA section 404 and they contain no authority or reasoning for disregarding the statute's requirement that participant and beneficiary interests be the sole, exclusive criteria for fiduciary decisionmaking.

Consider two final defenses of IB 94-1: First, that IB 94-1

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[48] Compare Reich, supra, note 46 with Reich, supra, note 9. As I emphasize below, note 68 infra, I am not criticizing Secretary Reich for altering his opinions. My thinking on these issues has evolved and it is appropriate that his has also. On the other hand, the change in Secretary Reich's views underscores the difference between the environment in which Mr. Lanoff promulgated his stance on social investing and the environment fourteen years later in which the DOL issued IB 94-1. Undoubtedly, the position adopted by Mr. Lanoff helped significantly in getting us where we are today. That position, however, has now served its purpose.

[49] See, e.g., Richard Rouco, "Available Remedies Under ERISA Section 502(a)," 45 Ala. L. Rev. 631 (1994).

does not primarily encourage ETIs, but principally reaffirms the duties of prudence and loyalty;[50] second, that pension trustees, confronted with otherwise equivalent investment choices, ought be permitted to weigh collateral economic benefits to break the tie. Pension trustees either must use some criterion to select from among commensurate alternatives or must select from among such alternatives randomly; ETI-type benefits are as good as any other possible tie-breaking criterion and more seemly than random selection.[51]

Neither exoneration of IB 94-1 is ultimately unconvincing. Pension trustees' obligations of prudence and loyalty do not need administrative confirmation; they are the core of ERISA's statutory scheme. Had IB 94-1 merely reiterated the exclusive benefit rule, it would have been a nonevent, a redundant restatement of the statute.

Indeed, the DOL's subsequent advocacy of ETIs leaves no doubt that IB 94-1 and the ETI clearinghouse are intended to promote such investments.[52]

For three reasons, it is equally unpersuasive to defend IB

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[50] See, e.g., Leon E. Irish, "Misunderstanding Social Investing," 64 Tax Notes 966 (August 15, 1994).

[51] This line of thought was suggested to me by the comments of Alvin D. Lurie, Esq., who reviewed an earlier draft of this article.

[52] See note 8, supra. See also "DOL Comments on Interpretive Bulletin Addressing ETIs," CCH Pension Plan Guide, No. 1025 at 8 (paraphrasing Morton Klevan, DOL's Senior Director of Policy and Legislative Analysis: "the DOL encourages ETIs as a tool for economic revitalization.")

94-1 as a tie-breaking device. First, using collateral benefits to select from among equivalent investments perpetuates the illusion that ETI polices accomplish something. If investments genuinely yield competitive, risk-adjusted returns -- the sine qua non of being ETIs -- market forces will clear such investments without consideration of their collateral benefits. Using ETI considerations to break ties suggests otherwise and thus misleads plan participants and others.

Second, determining the presence of collateral benefits can be costly for a pension plan. At a minimum, prudent plan trustees must spend their own time to divine and quantify the externalities allegedly flowing from particular investments. More typically, making such determinations requires trustees to hire experts -- economists, consultants, accountants, actuaries, investment bankers. There is, in contrast, no transactions costs to flipping a coin.

Third, using ETI criteria to select from among equivalent investments introduces into pension trustees' decisionmaking inappropriate pressures to make such investments. If collateral benefits are pension trustess' tie-breaking criterion, groups expecting to benefit from ETIs have strong incentives to compel such trustees to declare ties. These are precisely the kinds of pressures from which the exclusive benefit rule is intended to insulate pension fiduciaries.

The Harms of IB-94-1: ETIs as Privatized Industrial Policy

Given the essential unsoundness of the ETI concept, it is

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tempting to dismiss that concept as destined for irrelevance. However, for three reasons, the potential impact of IB 94-1 should not be underestimated.

First, in specific cases, IB 94-1 and its approval of ETIs will in practice alter the dynamics of fiduciary decisionmaking and thus induce the deployment of pension assets away from conventional investments and toward ETIs. Constituencies expecting to gain from particular ETIs' collateral benefits will be emboldened by the DOL's formal support for their interests while trustees who previously resisted such investments find their positions correspondingly weakened. Thus, in particular cases, IB 94-1 will accomplish its intended mission, i.e., to shift patterns of fiduciary investment towards ETIs.

Most susceptible to pressure from ETI advocates are public[53]

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[53] Technically, government plans are not subject to ERISA's fiduciary provisions and thus are not governed by IB 94-1. See ERISA Section 4(b)(1). In practice, however, IB 94-1 will have significant influence on government pension plans. Most public plans are subject, by statute or case law, to local versions of the duty of loyalty; given the common origins and purposes of ERISA's exclusive benefit rule and the local law duty of loyalty, as well as the DOL's role as the nation's prime administrative interpretter of pension fidicuary law, IB 94-1 will influence the state law understanding of the duty of loyalty.

More generally, IB 94-1 creates an atmosphere in which the nation's leading guardian of retirement funds approves of pensions' pursuit of collateral benefits. Such an atmosphere will embolden the constituencies seeking such benefits and demoralize those resisting ETIs.

See "Debate Over Social Investment Policy Continues During Foundation Conference," 12 BNA Pen. & Ben. Rptr. 1453 (Oct. 21, 1985) (citing remarks of Attorney Robert Klausner of the influence of federal pension law on state courts).

and multiemployer[54] plans. Government pension plans are ultimately directed, in whole or in part, by elected officials who select the trustees for such plans or who serve as such trustees themselves. It requires little imagination to postulate situations in which elected officials will deploy public pension funds to satisfy ETI constituencies or will encourage their appointees to use pension resources to accomodate such constituencies. Officials inclined to resist the pressures of ETI proponents now find their opposition undercut by IB 94-1 and the DOL's approval of such investments.

The dynamics of multiemployer plans are similar. Union trustees face potential ETI demands from their members and from colleagues in the labor movement. IB 94-1 has taken away the trump card of those multiemployer trustees tending to oppose such demands, i.e., the argument that ERISA's exclusive benefit rule and the DOL forbid consideration of collateral benefits.[55]

As an empirical matter, in the past public and multiemployer plans have, as this analysis suggests, demonstrated the most

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[54] For background on multiemployer plans, see Langbein and Wolk, supra, note 25 at 48-52.

[55] The management trustees of multiemployer plans might be expected to oppose ETIs since investment losses can impact on employers. However, these trustees frequently face collective action problems hampering their effectiveness. The typical multiemployer plan involves many small businesses; a management trustee often limits his time and energy on the plan's affairs since only a small proportion of his effort redounds to the advantage of his particular firm. Now that the DOL has placed its imprimatur on ETIs, even less attention to and resistance against such investments can be expected from these employer trustees.

pronounced proclivities toward ETIs because of their greater vulnerability to ETI constitutencies; IB 94-1 is likely to strengthen those proclivities in the future.

In contrast, private, single employer pension plans have, until now, shown little interest in ETIs. IB 94-1, however, will increase the ETI pressures on such plans. Consider, for example, a corporation seeking government approval or assistance (e.g., a zoning exemption, tax-exempt financing). IB 94-1 emboldens public officials to condition their consent upon the corporation's pension plan undertaking an ETI (e.g., an in-state investment sought by elected officials). In a similar fashion, IB 94-1 encourages corporations with serious public relations problems (e.g., tobacco companies) to deploy pension assets so as to portray themselves as responsible corporate citizens.[56]

If, in practice, ETIs carry competitive rates of return, the likely increase in ETI activity will be a charade which suggests to plan participants, shareholders, voters -- indeed, virtually everyone with an interest in pension plans -- that something is being accomplished when, in reality, market forces would have caused these investments to be made anyway.

It is, however, likely that many, if not most, investments labelled as ETIs will in fact generate below market returns. The

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[56] If the DOL challenges these sorts of investments under the prohibited transactions rules as, e.g., "transfer(s)...for the benefit of" employers, the employers have a compelling retort: that their plans are deploying pension capital in the pursuit of collateral benefits per IB 94-1. For background on the prohibited transactions rules, see note 33, supra.

proponents of IB 94-1 have already told us that ETIs are often found in poorly functioning markets; this strongly suggests that proposed ETIs will be declared economically competitive when there is no functioning market to test that declaration. Historical experience with ETIs further counsels that, once the door is opened to consideration of collateral benefits, such considerations crowd out basic financial concerns.

Consider, for example, the investment of the Connecticut state pension fund in Colt's Manufacturing Company, a large gun manufacturer and a major employer in the Hartford area.[57] When in 1990 Colt's fell on hard times, Connecticut treasurer[58] Franciso L. Borges spearheaded a twenty-five million dollar investment by the state pension fund in Colt's. Four years later, Colt's was again in bankruptcy with most of the fund's money lost.[59]

Here in a nutshell is the danger of economically targeted

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[57] For background on the Colt's saga, see Kirk Johnson, "Crying Betrayal in Hartford, Colt Faces Uncertain Future," N.Y. Times, June 12, 1993, Section 1 at page 1; John T. McQuiston, "Colt Unit Sold, Connecticut Among Buyers," N.Y. Times, March 23, 1990, Section B at page 1; Thomas Scheffey, "A Horse Divided: The Colt's Bankruptcy Saga," Conn. Law Trib., December 28, 1992 at 4.

[58] Connecticut elects its state treasurer; Mr. Borges successfully ran for re-election in 1990.

[59] The Connecticut pension fund invested $25 million in Colt in 1990; in 1994, the fund recovered $4.3 million in bankruptcy. While these numbers are dismal, they actually understate the loss sustained by Connecticut: the Connecticut Development Authority contributed $10 million to Colt's 1994 reorganization. Thus, in a important sense, the $4.3 million recovered by the pension fund merely came from Connecticut's taxpayers through another state agency.
See "Colt's has reason to celebrate," New Haven Register, October 4, 1994, Section D, page 2.

investing: While Borges claimed that the Colt's venture was financially sound and that job preservation was a secondary concern, it is hard to take that argument seriously; the more compelling characterization is that Connecticut state pension monies were used for an election year bail out of a failing firm and that basic economic considerations were discounted, if not ignored.[60]

Connecticut's ETI experience is by no means atypical.[61]

Of course, investments selected without regard to collateral benefits can also go bad. Indeed, when pension plans maintain well diversified portfolios, very lucrative investments are typically offset by losing ones. However, ETI policies compound pensions' risk of loss by subjecting trustees to pressures to subordinate financial concerns for the pursuit of collateral benefits which, in a case like Colt's, cease to be collateral but in reality become the raison d'etre of the investment.

The losses engendered by disregard of the exclusive benefit

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[60] Moreover, Borges and the other advocates of the Colt investment never satisfactorily confronted the negative externality of that investment: Colt makes and sells guns, a commodity of which many Connecticut cities already has a surfeit.

Indeed, there is evidence that Borges, the chief advocate of Connecticut's ETI in Colt's, did more than overlook the nature of the products produced by Colt's. See Johnson, supra, note 57 ("Having invested $25 million in Colt on a pledge by the former State Treasurer, Franciso L. Borges, that Colt did not make assault weapons, the legislature has now concluded that that is exactly what the company does.")

[61] See, e.g., James A. White, "Back-Yard Investing Yields Big Losses, Roils Kansas Pension System," Wall St. J., (August 21, 1991), Section A at 1 (reporting on the losses of the Kansas Public Employees Retirement System from in-state ETIs).

rule impact most directly on participants in defined contribution plans. Poor investment results diminish participants' accounts in such plans in comparison with the size such accounts would have achieved with better financial performance; losses actually reduce participants' defined contribution accounts and thus their retirement benefits. Hence, in this context, the incidence of below market ETIs falls straightforwardly upon participants and beneficiaries who receive smaller plan distributions than they otherwise would have.

The repercussions of ETI policies are more complex -- but equally unfavorable -- in the defined benefit setting. Since employers sponsoring defined benefit arrangements commit to specified benefits, poor investment performance initially impacts on such employers, obligated in the face of such performance to contribute extra amounts to pay for the benefits the employers have promised.

Nevertheless, in the defined benefit environment, participants do not necessarily escape the effects of inferior investments: employers sponsoring poorly-funded defined benefit plans are less likely and less able to agree to benefit increases than are employers whose plans are well-funded; when employers with fiscally sound plans augment benefits, individuals whose employers maintain inadequately financed plans either must migrate to other employers with fiscally secure plans or must accept less deferred compensation than their counterparts working in these other firms. This choice will be particularly costly for

individuals with firm-specific skills and entitlements, forced to abandon these skills and entitlements to obtain prevailing levels of deferred compensation.[62]

In particularly dire cases, financially weak employers sponsoring underfunded defined benefit plans default on the benefits they have promised. In some such cases, employees receive some redress from the employer's assets in bankruptcy or from the Pension Benefit Guaranty Corporation (PBGC), the government-sponsored insurance program for basic pension benefits. However, if the employer is not subject to PBGC coverage or if an employee's accrued benefits exceed the minimal level guaranteed by the PBGC, underfunding combined with employer default results in the employee losing some or all of the pension benefit he had earned.

Even if employers fully absorb the impact of below market ETI investments, the implications of such investments are troubling. In the case of publicly-sponsored plans, poor investment performance is a form of hidden taxation: Connecticut's taxpayers must replenish the state's pension fund for the cost of the Colt's fiasco. In the case of private plans, noncompetitive ETI projects diminish shareholder welfare when such projects compel the employer to compensate the defined benefit plan for its poor financial performance.

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[62] For a discussion of firm-specific skills and entitlements and their impairment of employees' mobility, see Edward A. Zelinsky, Against Albertson's II, ___ Tax Notes ____ (March 13, 1995) at .

A second reason for taking IB 94-1 seriously is that, in the long run, we can anticipate ETI proponents to press for mandatory ETI requirements. To date, the current leadership of the DOL has characterized ETIs as optional for pension trustees.[63] However, the underlying logic of IB 94-1 points in a different direction: if ETIs produce significant collateral benefits while traditional investments do not, it is socially inefficient for pensions to make traditional investments when ETIs earn the same risk-adjusted rate of return while also generating positive externalities. Thus, IB 94-1 is probably not the final position of ETI advocates but rather an initial foothold on the path to mandatory ETIs.

Finally, perhaps the most significant aspect of IB 94-1 is that it reincarnates the doctrine of industrial policy and thus reflects the appeal of that discredited doctrine to those interested in off-budget activism. During the early 1980s, several influential commentators advanced the notion of industrial policy as an antidote to the economic strategies of the Reagan administration. Chief among the advocates of industrial policy was the current Secretary of Labor and ETI proponent, Robert Reich.

The most distinctive premise of the industrial policy program was that government should "guide and accelerate market

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[63] See note 7, supra.

forces."[64] Thus, Secretary Reich stated, "the government's role in industry" should be "more open, more explicit, and more strategic." [65] In practical terms, this vision was to be implemented through such devices as government-financed and -operated banks which would "provide low-interest long-term loans to industries that agree to restructure themselves to become more competitive."[66] Capital in this vision was to be allocated not merely in response to market signals; rather, government was to oversee the operations of industry and the deployment of capital.[67]

Most industrial policy proponents, including Secretary

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[64] Robert B. Reich, The Next American Frontier (1983) at 278. See, also, Charles Wolf, Jr., "The new mercantilism," The Public Interest (No. 116, summer, 1994) at 96, 97-98 ("fundamental premise" of industrial policy is that "government should select certain industries, technologies, and firms whose advancement is of 'critical' importance for the economy as a whole, and accord the selected ones some form of preferential treatment -- whether through subsidies, tax advantages, import restrictions, special efforts to promote exports, or direct government financing for 'precommercial development' of putatively critical technologies." In this vision, government should encourage those industries generating "spillover benefits ['externalities'] that are presumed to accrue to other industries or to the economy as a whole.")

Id. at 14.

[66] Id. at 243.

[67] This, Secretary Reich assured us, did not imply "national planning, in which bureaucrats -- ignorant of or indifferent to market forces -- shift capital from industry to industry to nurture their favorite 'winners.'" Instead, the call was for "well-designed adjustment policies -- through which government seeks to promote market forces rather than to supplement them." Id. at 234 (emphasis in original).

Reich,[68] now say that their thinking has moved on. However, the similarities between the industrial policy program and IB 94-1 are too great to be accidental; IB 94-1 represents the second life of industrial policy conceived this time as a privatized enterprise: pension trustees are to fill the role previously assigned to government, guiding the society's allocation of capital with an acumen surpassing the wisdom of the market.

Industrial policy conducted by pension fiduciaries will suffer from the same deficiencies as industrial policy implemented directly by the government: There is no reason to believe pension trustees searching for collateral benefits can allocate capital more wisely, efficiently or farsightedly than can markets and traditional market criteria. Mixing the already complex mission of the pension system -- providing retirement benefits to employees -- with the new task of overseeing the market's allocation of capital will lead to confusion of roles, making it likely that neither assignment will be executed well. The constituencies most likely to promote ETIs are those groups losing in the competition of the market; ETIs will thus be used both to bail out failing industries and to satisfy constituencies

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[68] In making these observations, I do not intend to criticize Secretary Reich for altering his views over time. My owns thoughts in this area have changed over the years and I hope this is viewed as manifesting further reflection and experience.

On the other hand, the continuities between IB 94-1 and Secretary Reich's earlier views on industrial policy are striking.

My previous statement on the issues addressed here is Edward A. Zelinsky, "The Dilemma of the Local Social Investment: An Essay on 'Socially Responsible' Investing," 6 Cardozo Law Rev. 111 (1984). I earnestly implore the reader to leave this article unread.

promoting below market investments.

Particularly troubling are the possibilities of a mandatory ETI regime. It is a fairly short step from the federal government requiring that plans make ETIs to the federal government specifying which ETIs plans must make. Thus, the privatized version of industrial policy embodied in IB 94-1 could prove an initial step towards a more robust rendition in which the federal government, via control of the portfolios of pension plans, dominates the allocation of society's capital.[69]

Ultimately, IB 94-1, and its resurrection of industrial policy, is a manifestation of off-budget activism in an era when many policymakers perceive political and economic constraints as precluding more direct and open forms of governmental activity. IB 94-1 is thus part of a more general proclivity[70] to eschew explicit taxation and expenditures in favor of implicit forms of taxation and spending. Hence, IB 94-1 is, in the last analysis, not simply a problem of the pension community, but of all concerned that public policy be implemented with maximum directness and accountability.

Conclusion

[69] If the ETI concept as articulated in IB 94-1 were fundamentally sound, it might be worthwhile to incur the risk that this scenario will come to pass. However, given the incoherence of IB 94-1, there is no reason to hazard this possibility.

[70] Perhaps the most well-known manifestation of off-budget activism is the profusion of unfunded mandates imposed by the federal and state governments. See Zelinsky, Vand. L. Rev., supra, note 29. For other manifestations of this trend, see (cite to December, 1994 issue of Regulation)

While the DOL portrays IB 94-1 and its codification of the ETI concept as a routine confirmation of existing law, IB 94-1 is in fact an important and unfortunate development. IB 94-1 is illogical, unsound and inconsistent with the provisions of ERISA governing pension trustees' investment decisions. In its first incarnation, industrial policy came to be repudiated by even its originators; industrial policy does not deserve a second life in the form of the ETI. The DOL should withdraw IB 94-1 or Congress should repeal it.

The Seniors Coalition
ISSUE PAPER

The Seniors Coalition

TESTIMONY

ECONOMICALLY TARGETED INVESTMENTS: A BAD INVESTMENT FOR AMERICA'S FUTURE

PRESENTED TO THE
JOINT ECONOMIC COMMITTEE
UNITED STATES CONGRESS

DELIVERED BY
KIMBERLY SCHULD
LEGISLATIVE ANALYST

MAY 18, 1995

Protecting the Future You Have Earned

Washington D.C. Metro Office: 11166 Main Street, Suite 302 • Fairfax, Virginia 22030 • Phone (703) 591-0663

Economically Targeted Investments: A Bad Investment for America's Future

Mr. Chairman, thank you for inviting The Seniors Coalition here today to discuss the Administration's plan to encourage what it terms economically targeted investments with pension funds from America's workers.

In reviewing this issue, The Seniors Coalition has made its evaluation based upon what was in the best interest of the pensioner. The available evidence concerning economically targeted investments (ETIs) weighs heavily against the pension earner. We are specifically concerned that ETIs will politicize pension funds, provide lower returns on investments and stagnate efforts to increase national savings. For these reasons, The Seniors Coalition has taken a position against the pursuance of ETIs. Pensioners are protected by the current ERISA laws, and we feel that a program that encourages ETIs would violate much of the intent of ERISA.

The 1974 ERISA law explicitly protects pensioners by directing each pension fund manager to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan." This is not ambiguous language. It is intended to provide pension funds the strongest measure of protection from political or unethical manipulation. The pursuit of ETIs as an appropriate use of pension funds is simply and plainly political manipulation which is not in the best interest of the pensioner.

Politicization of Pension Funds

By encouraging private investments to realize political goals, the Administration is setting up the pension fund market for widespread fraud and ethics violations. It is difficult enough for a pension fund to find a good manager these days. To be a money manager, you don't necessarily have to demonstrate an ability to manage money. All you have to do is file form ADV with the Securities and Exchange Commission (SEC) and pay a $150 fee. That makes you a registered investment advisor with the right to handle investments for clients. No special credentials are needed. Even if you have a criminal background, the SEC will not automatically disqualify you from becoming a fund manager. A spokesperson for the SEC admits that "the SEC does not advocate or enforce any standard.[1]" If we pursue ETIs, every special interest in America will have reason to be involved in pension fund issues and the process of determining what constitutes an ETI. It is not hard to imagine lobbyists and corporate lawyers taking over as pension fund managers to ensure that their ETI receives as much money as possible.

The oil-and-water mix of politics and investing is invariably present with ETIs. Writing in the *Columbia Law Review* in 1993, pension expert Roberta Romano said that the political affiliation of many trustees makes public pensions especially vulnerable to pressure by state officials. One East Coast plan official said, "In many states, the office of treasurer is a quasi-

political office. People who aspire to political office do things that aren't in the interest of the fund." A West Coast counterpart said flatly, "Any drive to do ETIs comes from politically active members of the pension board.[2]" Although ETIs have thus far been largely confined to public pension funds, the potential for political conflict arising from attempts to capture the private pension market is alarming.

Promoting ETIs will place pension fund managers in a difficult position with torn loyalties. No longer will their explicit role be to invest the monies of pensioners in a manner which will produce the highest returns for the participants. Under an ETI program, fund managers will be subject to political manipulation. With Robert Reich's Interpretive Bulletin 94-1, the Department of Labor has already attempted to pull fund managers into the political fray by re-interpreting the ERISA law. By attempting to convince fund managers that ETIs are in compliance with ERISA, the Administration has already begun the subtle strategy of pushing managers toward ETIs. In fact, some pension fund officials report being "encouraged" to invest in ETIs. The chief of staff of one state fund says the federal government is using the threat of revoking pension funds' tax-exempt status to increase their receptiveness to ETIs. "They can enact tax policy to change the way people invest," says another fund official[3]. The bottom line is, when a money manager serves several masters, achieving equal treatment can be a tricky matter.

Beyond the effect of political influence of pension funds for the individual investor, there is the matter of who, or what agency, determines what investments will be considered ETIs. Every government agency or program that finds itself short of revenue, or cut out during the budget process, will declare investments that benefit the agency a good investment for pension funds. There is no avoiding the political manipulation that will surround the process by which ETIs are determined.

An existing example of the power of political influence over the agenda of a government agency is the Food and Drug Administration (FDA). For all its grandstanding, the FDA adjusts its priorities for expending resources in response to political pressure imposed from outside groups. There is no doubt that AIDS activists and breast cancer activists have played a significant role in the priority these two diseases are given in terms of time and money spent on research. Without question, these particular diseases are devastating and deserved of attention. But are they any more important than finding a cure for Alzheimer's or spina bifida or multiple sclerosis or muscular dystrophy? Unfortunately, our system of government responds to those who shout the loudest, and not always with great deliberation and concern for the good of the individual recipient. As pension funds are politicized, it will be the ETIs that shout the loudest that will receive the investments, without regard to whether or not they indeed represent the best investment for the pensioners.

The attempt of the Administration to obtain new revenues for its social agenda by robbing private pension funds is irresponsible to the individual investor. It is one more arena in which the government plans to place itself squarely between the earner, and the money he or she has earned.

Lower Returns on Investments

A large number of studies show that ETIs have much lower returns than other investments. For example, the experience of the Equitable Life Assurance Society, which has managed a $78.8 million real estate portfolio called the Community Mortgage Program for 16 years, suggests the assumption that ETIs boost the local economy and increase the long term investment return is false. Between 1978 and 1991, CMP, which Equitable calls the prototypical ETI program, under-performed all other major market indices[4]. In 1994, Olivia Mitchell, executive director of the Pension Research Council at the Wharton School, also found that investing in ETIs leads to lower overall returns.

Even President Clinton's pick for the Federal Reserve Board, Alicia Munnell, found that mortgage investments in 31 states almost all involved either an "inadvertent or deliberate sacrifice of return." In this 1983 study, it was determined that the few states that did achieve market rates of return did little to increase the aggregate supply of mortgage funds[5]. Additionally, further analysis of mortgage-related ETIs has shown that those programs that have generated competitive returns have done so at taxpayer expense. New York City's Community Preservation program's 12.7 percent return exceeded the Ginnie Mae bond return of 8.8 percent, but achieved this in part through a government subsidy of roughly 3 percent. As Roger Howeiler, head of the Seattle Employee Retirement System points out, such subsidies are essentially hidden taxes[6].

In an article distributed by Clinton's Labor Department, Richard Ferlauto identifies the fact that ETIs are not a strong investment, and plans must be made to subsidize their use. Why should taxpayers be expected to cover the losses of a bad investment to advance a social agenda they cannot identify? The argument that all communities will benefit, thus there is justification for pursuing ETIs, does not hold up in the current political, social or economic climate. The taxpayers end up holding the bag, and the pensioners are left with little to show for their hard work.

Stagnating Savings for Booming Retirements

The American savings rate is abysmally low. In a climate where experts of all political parties and persuasions are calling for increased private savings and investment, the Clinton plan to raid private pension funds is inappropriate and illogical. As a percentage of disposable income, our savings rate has declined from 8 percent in 1980 to 4.7 percent in 1994. The household savings rate in Japan is about 20 percent[7]. Alicia Munnell's suggestion to levy a tax of 15 percent on annual contributions and pension earnings at the fund level, as well as a one time assessment of 15 percent on existing funds, is dangerously dismissive of the fragility of our nation's savings rate. Why should Congress expect a machinist making $35,000 a year scrimp in his family's budget so he can contribute to his defined benefit plan just to be taxed for the effort?

Taxing private pension funds will not produce 15 percent more revenue. It will simply serve to reduce contributions to pension funds. When combined with the demographic trends facing us in the not-so-distant future, this scheme makes less sense than ever. As the baby

boomers retire, the government will need to start paying back the Social Security Trust Fund to accommodate their earned benefits. As this becomes difficult, benefits will likely be cut, taxes will likely go up, and retirees will need to rely more on their private savings. However, if the ETIs their pensions were invested in have fared poorly, where does this leave the retiree? It is unrealistic to expect people in the future to rely more heavily on private savings, and at the same time throw up barriers to increasing those savings.

Men and women 65 and over make up the country's fastest-growing age group. Simultaneously, the baby boomer population is entering middle age. This demographic surge occurs as the importance of pensions to retirees is also increasing. As the national savings rate has fallen, defined benefit plans — in which the employer promises to pay a specified amount to the retiree — are the only significant savings many people have[8]. Protecting these meager savings and providing incentives to grow them should be a top priority for Congress and the President.

Many pension funds are ill-prepared to meet these demographic changes as it is. According to a report issued by the Wyatt Company, a Washington, D.C. consulting firm, contributions to funds in the early 1990's fell 15 percent from the 1980's as Congress gradually chipped away at the amount employers can set aside in tax-qualified retirement plans. The effects of this decline can be seen in a 1991 General Accounting Office (GAO) study of 189 state and local plans that found 68 percent were underfunded, meaning they may not have adequate assets to meet future obligations. Underfunding is particularly worrisome because most state employees are over age 41 and expect to retire before age 60. "The proportion of pension plan participants receiving benefits rather than contributing to the plan could increase quickly in the near future," said the GAO[9].

Taking into consideration the fact that ETIs are not the soundest of investments, how do we balance this information against the need for increased private savings and investment? The fact is, we can't. This fact exposes the ETI scheme for what it is — a political attempt to raise more revenues for ill-defined, and sometimes unacceptable, social spending programs. This strategy of big government intervening in the free market to advance its own perception of "social good" is simply a redistribution of wealth.

Priorities for the Future

Rather than seeking new sources of revenue for more government spending, The Seniors Coalition challenges the Administration and Congress to seriously evaluate current spending trends and priorities. Entitlement spending will quickly engulf our entire federal budget. As that happens, it is likely benefits to retirees will be gradually reduced in an attempt to stretch the remaining funds as far as possible. Without encouraging increased private savings and investments with high yields, the effect of those looming reductions will be felt deeper by a larger number of people.

The current Administration's focus and goal of getting its hands on more revenue is irresponsible. When will they get the message that voters delivered last November — "It's our money, not the government's!"? It is ironic that Robert Reich, a self-proclaimed champion of the middle class, would pursue a policy that will so harshly effect the middle class when it retires.

Senator Connie Mack's and Representative Jim Saxton's measures to protect private pension funds and reaffirm the intent and duties of fund managers outlined in ERISA is a necessary step in staving off the attack on America's future — a step that one would wish should not have to be taken. The Seniors Coalition fully supports these efforts and endorses S. 774 and H.R. 1594. We look forward to working with the Members and staff of the Joint Economic Committee in seeking and promoting incentives to increase private savings and investment, wholly separate from political agendas and manipulation.

Thank you.

Endnotes

1. Sheets, K. "Money Managers Are Everywhere," Kiplinger's Personal Finance Magazine, February 1995, pg. 63-66.

2. "Retirees Pay for Pension Politics," Worth, April 1995, pg. 98-103.

3. Ibid

4. Ibid

5. Ibid

6. Ibid

7. Morgenson, G. "Why It's Dangerous to Dis the Dollar," Worth, September 1994, pg. 46.

8. "Retirees Pay for Pension Politics," Worth, April 1995, pg. 98-103.

9. Ibid

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Testimony of The Honorable Beau Boulter
on behalf of United Seniors Association, Inc.

Submitted to the
Joint Economic Committee

Hearing on Economically Targeted Investments
May 18, 1995

Good morning Chairman Mack, Vice Chairman Saxton and members of the Committee. Thank you for inviting me here today to testify on behalf of United Seniors Association. As a former member of Congress, it's always good to see so many of my old friends and colleagues.

As you are aware, current Department of Labor policies threaten the income security of seniors nationwide. Millions of seniors, as well as current workers, have planned and saved for the future counting on income from pension plans invested to maximize benefits in retirement. Now, hard-earned pension income is targeted by a Labor Department bent on tapping any funds it can get its hands on to pay for a liberal social agenda.

The Problem: Economically Targeted Investments

The Labor Department's recent action to encourage investments that seek social/political rather than monetary rewards represents a significant reversal of two decades of federal government policy. Twenty years ago, in the face of pressure from pensioners who feared misuse of funds, Congress passed ERISA legislation requiring pension fund investments to generate the greatest possible return. Since ERISA codifies pension fund managers' fiduciary responsibility to investors to invest funds for the sole benefit of the pension plan's beneficiaries, workers were relieved of any worry that the funds they had entrusted to pension managers would be misused.

Last summer, the Department of Labor redefined ERISA as it applies to pension fund investment, allowing public pension managers to consider "secondary benefits" to third parties in the investing process. The Clinton Administration euphemistically calls on public pension funds to invest in so-called Economically Target Investments (ETIs). ETIs are nothing more than Orwellian newspeak for big-government social programs. And now the Labor Department is putting the "hard sell" on fund managers in an attempt to use workers' pension funds to pay for dubious social welfare policies. The Department of Labor has even created a clearinghouse to determine what projects pension fund managers should subsidize.

Pension Income Jeopardized

Political pressure has led investors to use seniors' nest eggs to fund projects which yield *political benefits* for Big Government instead of *retirement security* for elderly Americans. Under Labor Secretary Robert Reich's Interpretive Bulletin #94-1, the financial benefit of workers who depend on pensions for retirement income is no longer the sole factor guiding prudent pension fund investment. Even if a third party benefits from risky investments in public housing or other projects, these non-monetary benefits do not accrue to

the investors who have (unknowingly) financed the investment.

Adding insult to injury is the fact that Americans who work hard to provide for their retirements *already* pay a significant portion of their income in taxes. This income is not available to be saved and invested for retirement or other purposes; instead it is used by government to pay for numerous social welfare programs and other government spending.

United Seniors Association believes money not taken directly by the government through taxation should remain under the control of the workers who have earned it, not the Department of Labor, or any other government agency. Until now, workers planning for their retirement could at least assume that their *pensions* were safe from the reach of big spenders in government, even though their tax dollars were not.

Since the American voters' anti-tax fervor has stymied the Clinton Administration's big-spending agenda, pension funds represent an opportunity to latch onto more money without pensioners even knowing about it. Denied the opportunity to raise taxes or pass unfunded mandates, tax-and-spenders must become raid-and-spenders. They simply can't resist the billions of dollars in pension funds available to pay for porkbarrel handouts.

The Clinton Administration's Pension Fund Raid

The Administration's unstated long-term goal is to require private pension funds to invest 5 to 10 percent of their pension fund assets into the Administration's hand-picked social welfare programs.

A five percent mandate would give the President Clinton about $175 billion to use for these so-called "investments." While this mandate is not yet law, Congress cannot simply ignore this issue. To date, the Department of Labor's promotional efforts have affected primarily public employees pension plans because they are not subject to ERISA's fiduciary standards. No member of Congress would be comfortable explaining that "only" the firefighters, teachers, and police officers have had their retirement funds "redirected" by an overreaching government.

The simple act of "allowing" pension managers to risk retirement savings on government-approved boondoggles should be enough to alert retirees and current workers to the dangers ahead. The slippery slope is particularly steep in this case. Already, several state legislators have introduced bills to require that a fixed percentage of pension funds be invested in government-sanctioned social programs.

Any such requirement necessarily reduces the retirement income of millions of workers who will collect pensions in the future. Already, we have witnessed several cases in which pension funds took heavy losses after investing in an ETI. For example, in 1980, the Alaska public employees and teachers retirement system put 35 percent of its assets into the state's mortgage market. When oil prices fell, 40 percent of the loans became delinquent or

were foreclosed. Pensioners paid the price. In 1989, the Connecticut State Trust Funds invested $25 million in Colt Manufacturing when the state government was under political pressure to preserve 1,000 jobs there. Colt filed for bankruptcy in 1992. The entire investment could be lost. Pensioners, not government, will pay the price.

Administration officials have acknowledged that using pension funds for social programs reduces the income those funds earn. That hasn't stopped them from pushing for the policy change. President Clinton's Assistant Treasury Secretary Alicia Munnell has recommended that the government tax private pension contributions by 15 percent a year, transferring $50 billion per year to ETIs. This despite a study she authored in 1983, in which she concluded that targeted social investments had assets that were significantly riskier, less liquid, and earned lower yields than private investments.

ETI's: The Next Savings & Loan Debacle?

As politically driven investments undermine pension earnings, they strain an already unstable pension system increasingly in danger because of underfunded plans. Weakening ERISA could create another savings and loan-type debacle. Then those same social planners who today want to raid the pension funds will turn to Congress for a costly bailout when their mismanagement leaves pension funds on the verge of bankruptcy.

With Social Security facing financial insolvency early in the next century, it is appalling that politicians would promote policies which jeopardize private pensions, abusing them to the point where financial returns are not maximized.

Workers look on pension contributions as part of their earnings. They work hard to build their pensions to ensure income security in retirement. The pension funds due to a worker are his property. The government cannot simply take these funds for its own purposes, without any authorization whatsoever. And yet that is exactly what the Department of Labor has done. It has unilaterally begun to raid pension funds. Weakening ERISA to pressure investments in government-sanctioned social programs is financially dangerous and ethically wrong.

United Seniors Association enthusiastically supports the Pension Protection Act of 1995, because it recognizes that pensions are for workers' retirement only. On behalf of our 400,000 members nationwide, United Seniors Association pledges to work for passage of this important legislation and looks forward to assisting you in these efforts.

Thank you.

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Before the Congress of the United States

Joint Economic Committee
on
Economically Targeted Investments

2226 Rayburn House Office Building
Washington, D.C.

May 17, 1995

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ECONOMICALLY TARGETED INVESTMENTS[1]

Thank you, Mr. Chairman, for this opportunity to comment on the potentials of prudent investments of the nation's pension funds toward the goal of a secure retirement for citizens and maximum positive impact of such investments on the economic health of American communities. The five million affiliated members of the National Council of Senior Citizens agree with you that public policy in the area of pension investment must continue to assure full protection for the rights of fund participants. We believe that economically-targeted investments, within the requirements of ERISA, play a positive role in expanding economic opportunities for citizens, communities and sometimes neglected sectors of the business community.

The subjects of this hearing, H.R. 1594 and S. 774 (the so-called "Pension Protection Act"), are based on the underlying assumptions that economically targeted investments have no place in investment practice and threaten the security of retirement benefits. If this were the case, the NCSC would be in the front lines opposing such activity. However, we stand in the front lines supporting the DOL Clearinghouse and the maturing of the ETI practice. We oppose H.R. 1594 and S. 774.

For over 30 years, a full decade before the passage of the Employee Retirement Income Security Act (ERISA), ETIs have helped make the American capital markets work better. It is well established that inefficiencies exist in our capital markets. As a consequence of these inefficiencies, many profitable, long-term and safe investments are

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[1] ETIs are asset classes that earn competitive risk-adjusted rates of return and also have targeted collateral benefits in terms of job creation and specific economic development. Examples include: venture capital, real estate mortgages, private infrastructure investing, private debt placements, local development efforts.

often not made because of redlining, distorted and incomplete information about new and small firms, and financial speculators divert money into fad investments causing more volatility, such as derivatives and junk bonds. ETIs provide viable and profitable alternatives to such practices.

For example, in the private sector, real estate development funds targeted by construction industry pension funds to create jobs provided a significantly better rate of return than competing funds. A 1991 survey of 16 leading open-ended real estate and mortgage trusts showed that, during a particularly tough market for real estate, targeted funds earned 4.2 and 2.9 percent, while benchmark non-targeted funds lost money.

Further, by expanding the total pool of investments available, ETIs are a sophisticated and profitable source of diversification which is key to minimizing risk for maximum return. Pension fund executives point to portfolio diversification as a major plus for ETIs.[2]

More recently, a 1995 GAO (*Public Pension Plans: Evaluation of Economically Targeted Investment Programs*, March) report showed that ETIs do not sacrifice rate of return to get social objectives. Specifically, the GAO concluded that "[the] case study results suggest cautious optimism concerning the ability of public pension plans to earn reasonable financial returns through their ETI programs."

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[2] "Are Alternative Investments Right for Your Pension Fund?" Healy, Thomas and Fiachra O'Driscoll, *Pension World* July 1992.

Pension funds, such as jointly union and management trusteed multi-employer pension funds, that have ETI investments, have done well. The Department of Labor's John Turner and Stuart Dorsey showed that union plans were safer and, as a result, their risk-adjusted rates of return were better than corporate plans. The Turner and Stuart study concluded that the multi-employer pension fund commitment to getting a good return, together with other economic and community feedback benefits does well for participants.[3]

Also, the Department of Housing and Urban Development project involving pension funds in rebuilding low-income neighborhoods earned an 11 percent return in the early 1990s (DOL).

Indeed, some earlier state and local pension fund attempts to obtain high rates of return and economic development in their home economies showed disappointing results.... Alaska, Kansas, Connecticut are the examples always used.[4]

However, Wall Street's "innovations" fail everyday—derivatives, real estate, company self-investing. These investments make up a much larger share of overall investment practice and cost pension funds significant losses. Ask workers and retirees from Cannon Mills, Eastern Airlines, TWA, Orange County and hundreds of other

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[3] Dorsey, Stuart and John Turner, "Multi-employer Pension Plan Investments, *Industrial and Labor Relations Review*, 1990.

[4] "Economically Targeted Investments: Data and Benchmarks" Testimony for the Advisory Council on Employee Welfare and Pension Benefit Plans, ETI Data and Analysis, Vancouver, WA, Jerry Housman (MIT), Dennis Logue and Wayne Marr.

pension sponsors what they think of "traditional" investing. Perhaps the energies of this Committee would be better utilized scrutinizing these examples of imprudent investments.

A 1983 Alicia Munnell study of public pension fund housing mortgage investments is often used as evidence that ETIs sacrifice return. The study was made in an immature ETI market 12 years ago. There was some statistical correlation, though slight, and the authors of the study cautioned against making strong conclusions about ETIs, especially since the study examined public pension investments not constrained by ERISA rules.

Of course, a crucial fact to remember in this discussion is that ETIs are small relative to the size of all investments—$65 billion out of $4.8 trillion of total pension fund capital in the U.S., or less than 1.4 percent. This means that 100 percent of ETIs could go bad and it would not significantly damage the pension system's ability to meet benefit obligations—a scenario that, given their history and the care with which they are pursued, is not at all likely.

Though small in relation to overall pension investments, as a dynamic trend that reflects how pension fund trustees and fiduciaries view themselves as impacting the nation's economy, the potential of ETIs is enormous. In 1994, pension funds became larger than banks. But, pension funds traditionally invest in Wall Street stocks and bonds while banks invest locally and for the long term. ETIs help replace those local-level investments which have been diminished with the decline in bank lending. This is important for the members of the NCSC. The Council has a long history of recognizing our stake in our communities and in the lives of our children and grandchildren. For

example, last year we supported approaches to health care reform. More recently, in the first week of May, the National Council successfully advanced Resolution #78 of the 1995 White House Conference on Aging which called on the nation to recognize that our..."ability to provide widespread economic security for all citizens, young and old, depends on the capacity of the economy to provide good paying jobs and to produce goods and services with competitive efficiency...." The same Resolution called on..."The Federal government to commit itself to a full-employment investment policy that increases real wages, allows greater savings and diminishes intergenerational economic conflicts."

We believe that the purposes of ETIs, within the context of prudence and competitive rates of return, are consistent with these values and we believe that the actions of this Administration and the Department of Labor in regard to ETIs are appropriate.

What the Saxton ETI Bill Will Do

As mentioned above, Pension Protection Act of 1995, attacks the decades-old concept of economically targeted investing, a mechanism that developed out of a recognition that capital markets are not perfect and that "Wall Street" does not invest in "Main Street." ETIs fill capital gaps through investment innovation that is not centered around financial gimmicks as in derivatives or speculative short-term trading but, instead, focuses on sound long-term creation of value, first for the investor and the overall economy.

Provisions of the Saxton Bill would have the serious consequences. Recision of the Department of Labor Interpretive Bulletin 94-1 would plunge investment innovation into the murky regulatory past where numerous opinion letters and obscure references made a clear understanding of ERISA inaccessible to pension plan trustees. Once again, the pension community would experience the chilling atmosphere of confusion and obscurity. By itself, the recision of IB 94-1 would ensure that the ETI concept would be practiced at the margin and underground to the detriment of pension recipients, funds and the economy.

The removal of funding for the ETI Clearinghouse would continue the state of limited and anecdotal information. Trustees would be denied needed data with which they could make informed investment decisions. An inevitable outcome would be that good ETIs would be stifled. Once again, investment innovation would be inhibited. Tragically, the dearth of information that the Saxton bill would produce would also limit ETI activity on the part of public sector plans—plans that are not even covered by ERISA.

The seeming preclusion of pension funds from investing in ETIs embodied in the "Sense of Congress" portion of the Saxton bill would rewrite 20 years of ERISA legislative, judicial and regulatory history. By substituting political considerations for the informed deliberation of pension fiduciaries acting on behalf of their plan participants and beneficiaries, the Saxton bill would place a practical bar on pension fund investments in ETIs. At best, this would drive ETI activity underground and out of the sunshine of

public scrutiny and study. It would certainly eliminate the latest wave of innovation in ETI activity aimed at carrying the concept to more areas of the economy suffering from capital gaps such as venture capital, small business, and industrial expansion—areas vital to the ability of the American economy to employ an expanding supply of workers.

At worst, the "Sense of Congress" provision would eliminate innovative products developed by a number of firms[5] from the investment mix available to pension fiduciaries, wipe out 30 years of investment history in which workers, through their pension funds, have invested in their own futures and start a witch-hunt for pension trustees who dared to think outside the narrow lines proscribed by Congress.

What is the next step? As drafted, it is possible that the Saxton bill could be extended to any type of investment activity that seeks to evaluate investments in a non-traditional way. For example, it is possible that the DOL initiative towards identifying the corporate winners of the future based on high performance workplace practices would be halted in its tracks. The development of such non-traditional measures of corporate performance was recommended by the bipartisan Competitiveness Policy Council established during the Bush Administration.

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[5] Such firms include household names such as IDS/American Express, Prudential, American Capital Strategies/Labor Research Inc., Massachusetts Financial Services, Morely Capital Management, Ark Asset Management, Lazard-Freres, Bear-Stearns, Cigna, The Equitable, Trust Company of the West, and J.P. Morgan. Along with lesser known but equally well established names like the AFL-CIO Housing Investment and Building Investment Trust, the Union Labor Life Insurance Company, the Multi-Employer Property Trust, and the Amalgamated Bank and Insurance Co.

Further H.R. 1594 could be the first step in a broad attack on progressive investment practice such as the growing shareholder activism on the part of pension funds. Such activism has helped ward-off destructive LBOs and takeovers such as the recent Kerkorian bid for Chrysler.

Mr. Chairman, we believe that the pensions of millions of current and future retirees will remain secure through economically targeted investments or more traditional initiatives as long as ERISA requirements are rigorously enforced. We believe that the current leadership of the Department of Labor is committed to such standards. ETIs can be the icing on the cake in terms of a vigorous and an innovative investment policy by the nation's pension funds. We can sleep well with such a policy.

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