TESTIMONY OF ROBERT GORDON CHAMBERS
ON BEHALF OF

McGUIREWOODS, LLP

BEFORE THE

SUBCOMMITTEE ON HEALTH, EMPLOYMENT, LABOR AND PENSIONS

OF THE

U.S. HOUSE OF REPRESENTATIVES EDUCATION AND LABOR COMMITTEE

FOR THE HEARING

ON

CREATING GREATER ACCOUNTING TRANSPARENCY FOR PENSIONERS

TUESDAY, JULY 20, 2010

TESTIMONY OF ROBERT GORDON CHAMBERS ON BEHALF OF McGUIREWOODS, LLP
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Introduction

My name is Robert Chambers, and I am a partner in the international law firm of McGuireWoods LLP. I have advised clients with respect to defined benefit plan issues since shortly after ERISA became effective. In that regard, my clients have included both large and small employers that sponsor defined benefit plans as well as financial institutions and other organizations that provide services to such plans. I am also a past chair of the Board of Directors of the American Benefits Council.

I appreciate the opportunity to present testimony with respect to the investment of defined benefit plan assets in hedge funds and private equity funds. Despite the general decline of the defined benefit ("DB") plan system, the investment of assets and funding of those DB plans that remain in effect have taken on increased importance for millions of Americans during difficult economic times. It is more important than ever to ensure that DB plans provide their participants with the retirement security that they promise. Our national priority should be an effective DB plan system that functions in a transparent manner and provides promised benefits, but without nonessential administrative burdens and unnecessary costs that would undermine the paramount purpose of the plans.

Due to the breadth of this hearing's topic, I have tried to anticipate several issues that may be discussed, and I apologize if I have failed to cover any of the intended issues.

My testimony will relate to the following subjects:

- The findings, conclusions, and recommendation reached in the April, 2008 report of the Government Accountability Office ("GAO") on investment of DB plan assets in hedge funds and private equity – GAO-08-692.

- The existence of other reports that the Department of Labor ("DOL") may use to provide guidance to plan fiduciaries regarding the decision-making process for such investments.

- The provisions of the Dodd-Frank financial reform bill that will require additional disclosure regarding hedge funds and private equity.

- The impact of such investments on other plan service providers.

- The existence of sufficient DB plan asset disclosure to participants.

The GAO Report Generally Reaches Logical, But What Are Now Dated Conclusions

The GAO necessarily hedged its view in developing the results and conclusions in its August 2008 report. It determined that:

- ♦ A growing number of plans have begun investing in hedge funds and private equity, yet most of such plans only invested a small portion of total assets in such investments.

- ♦ Many hedge fund and private equity investments appear to have more risk associated with them, yet virtually all of the fiduciaries interviewed indicated that they were generally pleased with the results of those investments.

- ♦ Hedge fund and private equity investments often require more due diligence to obtain necessary information and more negotiation of contract terms in order to make an informed investment decision, yet many fiduciaries are willing to devote this time and energy to the task in order to achieve the overall returns and volatility reduction that those investments can provide in accordance with a DB plan's funding and investment policy.

- ♦ Hedge fund and private equity investments often require longer term commitment and less liquidity than other types of investments, yet such fiduciaries deem those features to be less problematic in the context of projected liquidity needs in DB plans, especially in light of the opportunity for greater returns and less volatility that those investments, many of which are uncorrelated to traditional plan investments, may provide.

These GAO findings and conclusions certainly echo those of our clients that have explored investments in hedge and private equity funds.

The GAO report provides, correctly, that ERISA's fiduciary rules apply equally to both large and small DB plans, but that smaller DB plans may not have the resources to perform sufficient due diligence to properly assess non-traditional investments such as hedge and private equity funds. However, the report does not suggest that restrictions be placed on smaller plans. Rather, the report recommends that smaller plans should simply be apprised of the risks of such investments and the need for increased due diligence, negotiations, and monitoring to comply with ERISA's fiduciary rules.

If the DOL Decides to Provide Guidance to Plan Fiduciaries Regarding the Decision-Making Process for Investments in Hedge and Private Equity Funds, That Guidance Is Now Generally Available From Other Sources

The GAO Report concludes with a recommendation that the DOL provide guidance for plan fiduciaries that covers the special challenges relating to investments in hedge funds and private equity and the due diligence and other procedures that fiduciaries should undertake to

address these challenges. The report also suggests that the DOL provide additional information on these investments for small DB plans.

The DOL was provided an advance copy of a draft of the GAO report and responded that it foresaw a number of problems with satisfying the GAO's suggestion. The DOL's foremost concern was that providing such guidance would be extremely difficult in light of the lack of a uniform definition of such investments and the lack of uniformity of such funds and their underlying investments.

This concern may be put to rest in part because we can expect the SEC to provide definitional help as it issues regulations and other guidance under the Dodd-Frank financial reform bill discussed below. Further, as we await the issuance of this guidance, I believe that the DOL may make available the guidance suggested by the GAO without needing to reinvent the wheel and becoming entangled in a definitional morass. There are a number of existing, recent publications containing guidance on investing in hedge funds and private equity, several of which were drafted in connection with public sector initiatives.

For example, I draw your attention to *Principles and Best Practices for Hedge Fund Investors, the Report of the Investors' Committee to the President's Working Group on Financial Markets*. The report is dated, January 15, 2009. This document is available, among other places, on the Treasury Department's website.

This report includes a Fiduciary's Guide and an Investor's Guide. The Fiduciary's Guide provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The Investor's Guide provides recommendations to those charged with executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio. The principles and best practices are applied uniformly to both large and small investors.

The membership of the Investors' Committee included representatives of private and university endowments, large governmental and private pension funds, unions, and asset management firms.

My point simply is that the DOL could easily and quickly make available to plan fiduciaries the existing work of sophisticated, non-partisan groups that have developed excellent tools for handling the due diligence and contract negotiations for investments in hedge and private equity funds.

The Dodd-Frank Wall Street Reform and Consumer Protection Act Will Require Many Advisers To Hedge and Private Equity Funds to Register With the SEC and Provide Information Regarding the Funds

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank bill", which has not been signed by the President at the time that this testimony has been prepared) imposes registration and other disclosure requirements on many hedge funds and possibly on private equity funds. The Dodd-Frank bill gives the Securities and Exchange

Commission ("SEC") broad new powers with respect to managers of hedge and private equity funds. My firm expects that the SEC, the Financial Stability Oversight Council, and other regulators will provide needed guidance on definitions, registration requirements for larger advisors, the provision of required confidential data for virtually all of these funds, and methods of determining whether such funds are undertaking undue risk. Those agencies are authorized to take action against those advisers that are determined to have undertaken too much risk. This will assist the agencies in their attempts to monitor the hedge funds and private equity industries that grown so exponentially in the past few years.

Neither Congress nor the DOL should act at this time to restrict or prohibit DB plans from investing in any type of hedge or private equity funds. Plan sponsors are concerned such action would:

- Substitute Congress' current judgment regarding investments for the judgment of plan fiduciaries, who are familiar with their workforce and DB plan investment policies, liability management, funding issues, and administration;

- Establish an investment rule based on today's thinking that does not take into account future investment trends and principles;

- Lead to controversy and confusion (especially in the case of hedge funds~~),~~ regarding whether a particular series of investments creates a restricted or prohibited hedge fund;

- Send a signal to fiduciaries that particular investment options should be preferred over others; and

- Undercut consideration of a plan's funding and investment goals, risk tolerance, and interest in volatility reduction and investment diversification.

There Are Valuation Issues That Must Be Addressed for Some Investments in Hedge and Private Equity Funds

The administrators of all DB plans must make an annual filing of Form 5500 and its related schedules, which require a determination of the fair market value of all plan assets. Further, plan actuaries must obtain a valuation of all plan assets in order to complete their actuarial valuations. Similar to many other types of investments for which there is no public market or reported units sales, hedge funds and private equity investments present valuation challenges that can be difficult but are manageable.

The GAO report also noted the challenges DB plans face in valuing certain investments in hedge and private equity funds.

I expect that the SEC will develop additional valuation techniques as part of the guidance that it issues under the Dodd-Frank bill. I also understand that the Financial Accounting

Standards Board and the accounting industry are developing a systemized approach to the valuation of downstream investments for which there is no public market.

More generally, in the United States, the valuation of assets and liabilities of DB plans has never been required to be an exact science. For example, real estate and stock in privately held companies can be appraised, but the valuation cannot be precise. This is not a problem that renders such investments inappropriate for plans, rather it is an issue that plan fiduciaries must consider along with all other factors in deciding to invest in such an asset.

No Additional Information on Hedge and Private Equity Funds Needs To Be Provided To Plan Participants

Congress and the DOL have just reviewed the issue of disclosure of specific information regarding individual investments of a DB plan. The Pension Protection Act amended ~~Section~~ 101 of ERISA to require DB plan administrators to provide annual funding notices to participants that include a year-end market valuation of the plan's assets and liabilities and information regarding the plan's funding and investment policy, among other information. The DOL has issued a model notice that includes a chart illustrating the plan's year-end asset allocation by percentage of plan assets invested in up to 17 categories. To the credit of the DOL, this part of the model notice is relatively short, simple, and easy to understand.

It would be very unhelpful to revisit that issue. I have heard from numerous clients and colleagues that the amount of information being provided to participants has grown so great that participants have on the whole simply stopping looking at the disclosures. To add a set of complex new disclosures would simply reduce the number of participants who actually read what they receive.

The key is enabling plan fiduciaries to make informed decisions on behalf of the participants. That should be our focus, rather than so overwhelming participants with complex information that the disclosure regime becomes meaningless.

It is also important to remember that hedge funds, in particular, are not a separate asset class. Rather, they are a compilation of assets from one or more asset classes. Reforming existing rules to draw participants' attention to specific investments, whether in hedge funds, private equity, or other asset classes (such as real estate), invariably will be more confusing than enlightening.

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The DOL has consistently advised plan sponsors and other fiduciaries of the importance of creating appropriate procedures, following those procedures, reviewing the procedures from time to time in light of changes to best practices, and documenting such compliance and review. Fiduciaries will be judged primarily on their adherence to this process, rather than on the results of their decisions. The decision of whether to invest DB plan assets in hedge funds, private equity, and other non-traditional assets, and the monitoring of those investments, should not be

held to different standards. Nonetheless, I agree with the GAO report that the DOL would perform a valid public service by providing or making available guidance on specific issues that such investments generate. That guidance, which is already available, will need to be reviewed and updated in the future to take into consideration accounting developments and guidance issued by other agencies as they implement recent legislation.