Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions

Introduction

Whenever the ownership and control of property are separated, owners face the possibility that their property will be managed not for their benefit, but for the benefit of its controllers. Owners, therefore, must act to protect their property against expropriation by controllers with divergent interests. At present, pension funds constitute the largest single source of investment capital in the United States. This Comment examines both the extent to which trustee management of state and local public pension funds separates the interests of owners from those of controllers. The author would like to thank Professor Roberta Romano and Mr. Marc Kruithof for their comments on earlier drafts.


2. STAFF OF THE HOUSE COMM. ON EDUCATION AND LABOR, 95TH CONG., 2D SESS., TASK FORCE REPORT ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS 129 (Comm. Print 1978) [hereinafter cited as TASK FORCE REPORT] (the estimate of the size of pension investment funds includes both public and private funds). This Comment focuses on the regulatory provisions that control the investment decisions of fund trustees. It does not specifically consider the funding problems which plague public plans. Many of the arguments proposed herein, however, are equally applicable to funding issues. Neither does this Comment consider the policy implications of the essentially private retirement system currently in place in the United States. The Comment accepts the existing pension framework including both public and private plans without expressing a view as to this framework's desirability.

3. This Comment discusses only pension plans for state and local government employees. Although the arguments made in this Comment may have implications for pension plans for federal government employees, those implications will not be discussed herein. Any reference to "public plans" or "public funds," therefore, is intended to refer only to state or local government plans or funds. Generally, public plans can be categorized by level of administration. Over 80% of public plans are administered at the city and township levels. State governments administer only 9.6% of the total number of public plans. TASK FORCE REPORT, supra note 2, at 56.

The growing importance of public plans is demonstrated by the recent dramatic expansion of public plan assets. According to best estimates for 1982, public pension funds held $265 billion in assets. Public Employee Pension Benefit Plans: Joint Hearings Before the Subcomm. on Oversight of the Comm. on Ways and Means and Subcomm. on Labor-Management Relations of the Comm. on Education and Labor, 98th Cong., 1st Sess. 57, 58 (1983) (statement of Alicia H. Munnell, Vice President and Economist, Federal Reserve Bank of Boston) [hereinafter cited as Hearings]. Within 15 years, the value of those funds is expected to exceed one trillion dollars. Id. at 140 (statement of John J. Sweeney, President, Service Employees International Union, AFL-CIO, accompanied by Steve Pruitt, Legislative Director).
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rates ownership and control into groups with divergent interests and the measures necessary to align those interests to insure that management of public funds benefits their owner/participants.

The first section of the Comment outlines current regulation governing the investment of public pension funds and concludes that, at present, despite an apparent disparity in returns on public funds as compared with similar investment funds, there exist no effective regulations limiting trustees to investments which benefit plan participants. Even worse, current regulation does not discourage, and in many states requires, the use of trustees who possess clear conflicts of interest with plan participants. The second section addresses both the constitutionality and the desirability of federal regulation of public pension fund trustees. First, it concludes that federal regulation would be a constitutional exercise of Congress’s Commerce Clause powers under the standard recently enunciated by the Supreme Court in Garcia v. San Antonio Metropolitan Transit

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4. Public pension plans are established by state and local governments to provide retirement income for their employees. Murphy, Regulating Public Employee Retirement Systems for Portfolio Efficiency, 67 MINN. L. REV. 211, 213-24 (1982) states that:

The primary reason for the establishment of pension plans, whether public or private, is to provide employees with a source of income during retirement. ... Employer pension plans developed as an integral component of the nation’s retirement system to fill the gap between the level of income need for employees to maintain an adequate standard of living during retirement and the level of income provided by social security and personal savings.

See also L. KOHLMEIER, CONFLICTS OF INTEREST: STATE AND LOCAL PENSION FUND ASSET MANAGEMENT 4 (1976). Public pension funds were originally started to compensate police officers and firemen for the dangerousness of their work. At this time, public employee wages were generally lower than those of the private sector. While pay scales for the public and private sector are currently almost equal, pension plans continue to offer more liberal benefits in the public sector. Id. at 7; Herbert, Investment Regulation and Conflicts of Interest in Employer-Managed Pension Plans, 17 B.C. INDUS. & COM. L. REV. 127, 132 n.42 (1976) (employer-sponsored pension benefits increase employee productivity and longevity of service).

5. For a discussion of the extent to which fund participants have an ownership interest in their expected benefits, see infra note 74 and accompanying text.

6. For example, from 1970-1980, insurance companies earned an average annual return of 6.5%. A. MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 109 (1982). During the same period, public funds earned approximately 5.8%. Hearings, supra note 3, at 141 (Statement of John J. Sweeny, President, Service Employees International Union, AFL-CIO, accompanied by Steve Pruitt, Legislative Director). In 1981, the annual rate of return on public funds was 3.3%. Id. See also TASK FORCE REPORT, supra note 2, at 131 (rate of return on public plans was 5.4-5.5% in 1975). The importance of this difference is underscored by the fact that the percentage point difference in annual rate of return supports either a 20% decrease in the cost of providing pensions or a 25% increase in pension benefits to fund participants. See T. BLEARNEY, RETIREMENT SYSTEMS FOR PUBLIC EMPLOYEES 131 (1972); Herbert, supra note 4, at 136 n.7.

7. See infra notes 71-106 and accompanying text.

8. See infra notes 43-70 and accompanying text.
Second, it argues that regulation of trustee investment decisions is desirable because no market mechanism functions to align the divergent interests of public plan trustees and participants. Finally, it argues that the federal government is the appropriate regulator because state regulation of state-controlled funds vests the monitoring of trustee investment decisions in an entity, the state, which, in its role as a controller of the fund, possesses interests at odds with those of fund participants. The last section of the Comment considers the special problems federal legislators face in drafting regulations to control public fund trustees.

I. The Current Regulatory Framework

Regulations governing public funds exist at both the state and federal levels. At present, the federal government attempts to control public funds primarily through income tax regulations. Broader regulation of public funds and their trustees has been left to the states, which have responded by subjecting trustees to both general fiduciary standards and specific limitations on investment choices. None of these regulations adequately insure that trustees invest for the benefit of fund participants.

A. Federal Regulation

On the federal level, it is well settled that any trust which is part of a private retirement plan is tax exempt only if the plan meets the requirements of section 401 of the Internal Revenue Code. Since

10. See infra notes 133-68 and accompanying text.
11. See infra notes 168-85 and accompanying text.
12. See infra notes 186-236 and accompanying text.
13. TASK FORCE REPORT, supra note 2, at 2. See also Hearings, supra note 3, at 84, 87 (Statement of the American Federation of State, County and Local Employees); Campbell & Josephson, Public Pension Trustees Pursuit of Social Goals, 24 WASH. U. J. URB. & CONTEMP. L. 43, 57 (1983); Note, Public Employee Pensions in Times of Fiscal Distress, 90 HARV. L. REV. 992 n.3 (1977) [hereinafter cited as Fiscal Distress]. Although other sources of federal regulation do allow for review of some aspects of public pension fund management, they do not address the investment decision. TASK FORCE REPORT, supra note 2, at 7-42. Moreover, "the absence of any single federal agency to coordinate the administration and enforcement of the various federal laws relating to retirement income has precluded the development of a uniform national policy with regard to public employee retirement systems." Id. at 2. Importantly, public plans are not affected by either the National Labor Relations Act, 29 U.S.C. § 206(d) (1982), or the Labor Management Relations Act of 1947, 29 U.S.C. § 141. (1982). These Acts establish the right of employees to bargain collectively through representatives of their choosing for the terms of pension and welfare plans. State and local employees are specifically excluded from coverage under the Acts. See TASK FORCE REPORT, supra note 2, at 38.
14. See TASK FORCE REPORT, supra note 2, at 32; Campbell & Josephson, supra note
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1972, the Internal Revenue Service has taken the position that government-sponsored public employee retirement plans must also meet the requirements of section 401(a) in order to enjoy the tax benefits of a qualified plan.\textsuperscript{15}

In order to qualify for tax exempt status, pension plans must, \textit{inter alia}, be organized for the exclusive benefit of employees, provide definitely determinable benefits, satisfy anti-discrimination rules and provide full vesting on discontinuance or termination of the plan.\textsuperscript{16} If these standards could be enforced against public pension plans by the Internal Revenue Service, many of the problems addressed by this Comment would be solved. In practice, however, it is impossible for the Internal Revenue Service effectively to regulate public pension fund trustees.\textsuperscript{17}

The sanction for failure to meet the requirements of section 401(a) is disqualification of the plan.\textsuperscript{18} This sanction functions as a significant deterrent in the private sector because disqualification subjects the plan to taxation. The only consequence of disqualifying a public plan, however, is the cancellation of special tax benefits provided the employees.\textsuperscript{19} Enforcing section 401(a) for public

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13. at 57-58. The Employment Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (1982), ERISA, changed many of the provisions applicable to private plan qualification. Public plans were exempted from ERISA. Public plans, therefore, continue to be covered by the provisions of the Internal Revenue Code (I.R.C.) in effect when ERISA was enacted on September 1, 1974. \textit{Id.} at 58 n.76.


16. Section 401 of the I.R.C. sets forth three tiers of protection. \textit{See} Campbell & Josephson, \textit{supra} note 13, at 85. Section 401(a) of the I.R.C. requires that the trust be created or organized "for the exclusive benefit of his employees or their beneficiaries." Section 401(a)(1) requires that any contributions made to the trust be "for the purpose of distributing to such employees or their beneficiaries the corpus and income accumulated by the trust." Section 401(a)(2) requires that trust funds be used "for the exclusive benefit of the employees and their beneficiaries." Section 503 sets forth transactions which are prohibited to public plans including the proscription under section 503(b) of any transactions between affiliated persons and the plan which are unfair to the plan. \textit{See} \textit{id.} at 86.

17. \textit{See Task Force Report, supra} note 2, at 33 (interpretation by IRS that public plans are subject to qualification requirements "has had virtually no practical significance for state and local plans. Enforcement of the qualification standards against public plans has been for the most part non-existent."). The Internal Revenue Service, moreover, has stated both that the "exclusive benefit rule" does not prevent others drawing some benefit from a transaction with the trust, and that the rule only requires that the \textit{primary purpose} of the investment be to benefit employees. Herbert, \textit{supra} note 4, at 141 (citing Rev. Rul. 73-380, 1973-72 Cum. Bull. 124, 125); Rev. Rul. 69-494, 1969-2 Cum. Bull. 88; Campbell & Josephson, \textit{supra} note 13, at 85.


19. \textit{Task Force Report, supra} note 2, at 30, states that:
plans, thus harms the public pension plan participant rather than the plan sponsor, even though the participant may have had little or no control over the activities which caused the disqualification.\textsuperscript{20} Tax sanctions are thus not an effective means of regulating public pension plan trustees.

The realization that enforcement harmed only innocent plan participants, coupled with the complexity involved in enforcing section 401(a) for public plans, led the Internal Revenue Service, in 1977, to announce that, until a study could be made of the problem, all disputes over qualification under section 401(a) would be settled in favor of the taxpayer or governmental unit.\textsuperscript{21} This announcement remains in effect today; by holding to it, the Internal Revenue Service, and with it the federal government, has effectively withdrawn from any attempt at regulating public plans.

B. \textit{State Regulation}\textsuperscript{22}

Public pension fund trustees have two basic duties when manag-
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First, they must act at all times with strict loyalty to fund participants and their beneficiaries. Second, they must administer the funds of the trust prudently. This prudence requirement is implemented in two ways: broad definitions of generally acceptable standards for investment conduct and specific restrictions on investment choice.

The interplay of these fiduciary duties was illuminated in the recent case of Withers v. Teachers Retirement System. In Withers, beneficiaries of the Teachers Retirement System (TRS) of the city of New York alleged that a decision by TRS trustees to purchase $860 million of New York City bonds violated the trustees’ fiduciary duties to plan beneficiaries. Under New York law, public fund trustees have

information concerning those plans. For example, even the number of public plans can only be approximated. A 1978 congressional study cited the existence of 6,000 plans, yet the annual census of governments for that year reports only 3,075. Hearings, supra note 3, at 57, 58 (statement of Alicia H. Munnel, Vice President and Economist, Federal Reserve Bank of Boston). The lack of information regarding public plans results from an absence of systematic procedures for gathering data on the plans; few state statutes impose adequate disclosure requirements and public funds have generally failed to provide information independently. For example, asset values of public funds can only be approximated because 60-70% of public funds do not disclose the market value of their assets. Task Force Report, supra note 2, at 131, 186. Lieb & Kolman, How Much Regulation Do Public Plans Need, Pension World 22, 24 (August 1978), reprinted in Hearings, supra note 3, at 127-31. Reporting assets at book value is misleading and may overstate asset value. L. Kohlmeier, supra note 4, at 5. Even when funds do disclose information, the information’s accuracy remains open to question. Independent external audits of public pension plans are generally not required and are almost never conducted on a regular basis. Some plans have never been audited. Task Force Report, supra note 2, at 81, 186. The absence of independent audits increases the possibility of abuse. Task Force Report, supra note 2, at 69.

23. Campbell & Josephson, supra note 13, at 48. The basic rules involving investment decisions by public pension fund trustees derive from the common law of trusts. Id. at 50. Moreover, statutes applicable to the investment decision often incorporate these common law concepts. Id. at 48, 50, 67. See generally Herbert, supra note 4, at 143-147 (discussing trust law applicable to private trusts before passage of ERISA).


28. These purchases were specially authorized by state statute. 1975 N.Y. Laws ch. 890, as amended by 1978 N.Y. Laws chs. 488 & 785. Chapter 890 authorized TRS trustees to consider, in connection with investment in New York city bonds, the extent to which this investment would help the city fulfill its obligation to fund participants. These provisions of Chapter 890 were approved by Pub. L. 94-236 which permitted New York
the same investment powers as do the trustees of savings banks. These investment powers are defined by a "legal list" of permissible investments which includes municipal bonds.

In analyzing the prudence of the investment decision by TRS trustees, the court first determined that the purchase was statutorily authorized because municipal bonds were included on the legal list. Second, the court considered whether the trustees had exercised prudence with respect to their investment, that is, whether the specific New York municipal bonds purchased represented a responsible investment. At this level of analysis, the court applied the common law fiduciary standard of the "prudent man." The court looked to whether the trustees had "...employ[ed] such diligence and such prudence in the care and management [of the fund], as, in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs." In accord with the general rule in New York, the court examined the merits of the individual investment decision without considering its effect on the trust's over-all portfolio of assets.

The court upheld the trustees' decision in light of the fact that, without the TRS bond purchase, the city arguably would have gone bankrupt. Because TRS was not "fully funded," and because


It is not clear, however, that the Withers court relied on statutory provisions in upholding the TRS trustees' investment decision. See Campbell & Josephson, supra note 13, at 100-01.

32. Id. (quoting King v. Talbot, 40 N.Y. 76, 85-86 (1869)). Generally, the New York courts apply a somewhat stricter standard than courts in most other states. In New York, a trustee must act as "...a cautious prudent investor who is more interested in preserving capital than in taking the risks necessary for significant capital appreciation." Campbell & Josephson, supra note 13, at 49 (citing A. Scott, supra note 24, § 227.3 at 1812).
33. 447 F. Supp. at 1255. See Campbell & Josephson, supra note 13, at 49 ("In New York and other jurisdictions following traditional common law principles, a fiduciary must exercise the same prudence with respect to each investment decision."); Id. at 96-97 (citing King v. Talbot, 40 N.Y. 76, 90 (1869) for the proposition that "...it is the common law view that the prudence of each individual investment is weighed separately and that gains from one investment may not be used to excuse losses from another").
34. 447 F. Supp. at 1251. Funding is the systematic scheduling of contributions to a pension fund based on its long term needs. See L. Kohlmeier, supra note 4, at 5. Most public plans are funded. See Task Force Report, supra note 2, at 145; Murphy, supra note 4, at 214. The growing consensus that public plans should be funded is important.
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TRS’s principal asset was the city’s contractual obligation to pay benefits, the court held that the trustees had acted in the best interest of the plan participants by acting to assist the city in avoiding potential bankruptcy.35

The Withers court also considered possible trustee conflicts of interest in the context of public plans.36 The plaintiffs in Withers asserted that the fact that one TRS trustee was employed as the deputy comptroller of the City of New York rendered him incapable of fairly representing the interests of the beneficiaries of the fund.37 In his role as a city official, this trustee had helped develop, and remained an active proponent of, the city’s financial recovery plan.38 The court held that this conflict of interest did not preclude the city official from acting as trustee for the public fund, but only created “an especial obligation to act fairly on behalf of those concerned with the results of the action taken.”39

Withers thus stands for the proposition that, when fiduciary relationships create conflicts of interest which are authorized by statute, the judiciary is limited to the issue of whether the trustee has acted in good faith.40 The essential problem with the Withers standard is that it is unrealistic to expect that a trustee with a conflict of interest

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35. Withers v. Teachers Retirement System, 447 F. Supp. at 1259. Scholars have concluded that if there were no emergency, the trustees may not have been permitted to look beyond traditional factors of safety, return and diversification. See Campbell & Josephson, supra note 13, at 99; Langbein & Posner, supra note 26, at 101-02.

36. 447 F. Supp. at 1256.

37. Id. See also L. Kohlmeier, supra note 4, at 9 (“The dual roles of trustees, pension fund administrators, and investment managers are at the heart of almost all of the conflict-of-interest problems of public funds.”).

38. Id. Cf. Campbell & Josephson, supra note 13, at 73 (discussing similar problems of other New York trustees).

39. 447 F. Supp. at 1256 (quoting Westchester Chapter, Civil Serv. Employee’s Ass’n v. Levitt, 37 N.Y.2d 519, 521, 375 N.Y.S.2d 294, 295, 337 N.E.2d 748, 749 (1975) (per curiam)).

40. Cf. Donovan v. Bierwerth, 680 F.2d 263 (2d Cir. 1981), cert. den., 459 U.S. 1069 (1982) (even good faith belief in quality of his actions would not insulate trustee of private fund from liability under ERISA when he had not made proper investigation prior to investing). These cases can be distinguished based upon the quality of the investigation. See Campbell & Josephson, supra note 13, at 105-07. See generally id., at 70-80 (discussing issues raised by authorized conflicts of interest).
will be able to change roles as circumstances demand and act in
good faith at all times for all parties concerned.\textsuperscript{41} Such an expecta-
tion is particularly unrealistic for trustees, also government officials,
whose future careers may depend much more on the success of the
government as a whole than on the performance of a single pension
plan.\textsuperscript{42}

Withers thus exemplifies two major problems with the current reg-
ulation of public pension fund trustees. First, the case demonstrates
the inadequacy of the courts' current approach to the problems
posed by public plan trustees' conflicts of interest. Second, it dem-
onstrates that reliance on a legal list in conjunction with a general
fiduciary standard may be insufficient to prevent trustees from mak-
ing investments not solely for the benefit of plan participants.

1. Conflicts of Interest

The trustee's duty of loyalty requires that he administer the fund
of the trust solely in the interest of plan participants and their bene-
fi ciaries.\textsuperscript{43} Thus, for example, investments of public pension fund
assets for purposes other than the payment of benefits to plan par-

\textsuperscript{41} See Note, Conflicts of Interest Arising Under ERISA's Fiduciary Standards: Can the
Trustee Ever Be Prudent, As Long As He Faces Dual Loyalties?, 9 NOVA L.J. 413 (1985) (arguing
that corporate officers should be disallowed from acting as pension fund trustees under
ERISA). But see Herbert, supra note 4, at 165 (arguing that dual loyalties require that
specific investment restrictions be reinstated).

\textsuperscript{42} See TASK FORCE REPORT, supra note 2, at 206-07 app. I, Table 8. Eighty percent
of public plans have one or more government official on their board. In approximately
50\% of public plans, government officials make up more than one-third of the board. In
approximately 40\% of public plans, government officials make up more than half of the
board. In 28\% of public plans, employees have no board representation. Id. Fewer than
1\% of boards of public plans have members who are employed outside government in
fields related to investments. Id. at 67. See also L. KOHLMIEIER, supra note 4, at 17; Camp-
bell & Josephson, supra note 13, at 70-72. Union officials who act as pension fund trust-
nees may also have conflicts of interest. See Blankenship v. Boyle, 329 F. Supp. 1089
(1971) (union trustees' maintenance of large amount of cash in union-owned bank at no
interest and purchase of utility stock both held to breach fiduciary duty because primar-
ily for benefit of union). For comparisons of Blankenship and Withers, see Langbein &
Posner, supra note 26, at 97-104 (stressing special factors which made TRS purchase
justifiable under traditional trust law); Ravikoff & Curzan, supra note 26, at 521-23
(1980) (arguing that Withers permits trustees to compromise traditional objectives);
Hutchinson & Cole, Legal Standards Governing Investment of Pension Assets for Social and Polit-
ical Goals, 128 U. PENN. L. REV. 1341, 1362 (1980) (noting that New York city was princi-
pal contributor to funds).

\textsuperscript{43} See A. SCOTT, supra note 24, § 170 at 1298. The duty of loyalty is particularly
intense in the context of a trust created to provide economic support for specific benefi-
ciaries. Campbell & Josephson, supra note 13, at 67. However, under the current regu-
latory structure, persons administrating public pension plans are rarely obligated to
carry out their duties solely in the interest of plan beneficiaries. See TASK FORCE REPORT,
supra note 2, at 71.
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Participants should violate the trustee's duty of loyalty. More generally, the trustee's duty of loyalty should prohibit all transactions posing conflicts of interest. For public pension fund trustees, conflicts arise in three contexts. The most obvious conflicts arise when the trustee has a personal interest in a transaction involving fund assets. The classic example of this problem involves a trustee's purchase of trust assets. Conflicts may also arise where the interests of the various beneficiaries of the trust diverge. In the context of retirement plans, a pertinent example would be the existence of divergent interests between retirees and those still working. Finally, a trustee may have a conflict between the duty he owes to the plan participants and the duty he owes to the interest of another entity. This conflict is especially prevalent among public pension plan trustees who often represent the very governmental

44. Campbell & Josephson, supra note 13, at 45.
45. Id. at 68 (citing In re Ryan, 291 N.Y. 376, 52 N.E.2d 909 (1943) for the proposition that, "The general duty of loyalty is a flat prohibition of all transactions involving personal conflicts of interest."). See generally Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardoza, J.) ("A trustee is held to something stricter than the morals of the market place. Not honestly alone, but the punctilio of an honor the most sensitive, is thus the standard of behavior.").
46. Campbell & Josephson, supra note 13, at 67-68. Although the interests of public employees and employers in sound pension fund management should, in theory, coincide, in practice many conflicts of interest arise. See L. Kohlmeier, supra note 4, at 51. ERISA was passed, in part, to stem similar potential conflicts of interest in private retirement systems. Id. at 7. Potential conflicts of interest arise whenever a trustee has two duties. Campbell & Josephson, supra note 13, at 69. Actual conflicts arise when these duties conflict with one another. Id. at 70. "The trustee's duty of loyalty is the duty to act in the interest of the trust as if the trustee had no interest of his own to protect." Id. at 50.
47. Campbell & Josephson, supra note 13, at 67.
48. See A. Scott, supra note 24, § 170.1 at 1299-1304.
49. Campbell & Josephson, supra note 13, at 67. The potential for dual loyalties faced by public pension trustees is exacerbated because they have overlapping as well as successive beneficiaries. Id. at 94-95.
50. See id., at 82-83, 94-95; Murphy, supra note 4, at 222-23. In Withers, for example, those still working may have had a stronger interest in maintaining the long term solvency of the city than those already retired.
51. Public pension fund trustees are usually state or government officials, union leaders or investment bankers. Fiscal Distress, supra note 13, at 1013. These individuals all may have duties which conflict with those of the trust. See Campbell & Josephson, supra note 13, at 71. Government officials have compelling personal, political and governmental reasons for favoring investments which benefit their constituencies. Fiscal Distress, supra note 13, at 1014. Union leaders have an interest in increasing their power with the union. "[T]he risk cannot be overlooked that union representatives on occasion may see fit to bargain for improved wages or other conditions favoring active employees of the expense of retirees' benefits." Allied Chem. & Alkali Workers v. Pittsburgh Plate Glass Co., 404 U.S. 157, 171 (1971). See also Blankenship v. Boyle, 329 F. Supp. 1089 (1971) (union trustee breached trust when he used assets of pension fund primarily for benefit of union). Investment bankers may also have interests, such as prior investment in municipal bonds, which conflict with the interests of fund participants. See Fiscal Distress, supra note 13, at 1014.
entity which sponsors the fund.52

A recent trend among public plans has been increased investment in local enterprises as a means of promoting regional economic vitality.53 Common examples of locally targeted investments include municipal bonds and mortgages.54 Withers provides one example of the trend.55 Local investments are necessarily suspect when made by public officials who are in a position to gain personally and/or professionally from such investments.56

Investments targeted to the local community may not conform to traditional investment criteria for a number of reasons. First, local investing may result in an underdiversified portfolio of assets.57 Second, locally targeted investment may increase administrative costs, resulting in a lower net return to the fund.58 Third, government-sponsored securities such as municipal bonds pay lower returns because they are tax exempt. Public pension funds are also

52. See supra note 42 and accompanying text. The dangers of using state representatives as public pension trustees was demonstrated in Oklahoma in 1975 when the former governor was convicted of accepting a bribe to influence the state retirement board’s investment policies. See L. Kohlmeier, supra note 4, at 20. See also Campbell & Josephson, supra note 13, at 71-2 (explaining conflicts of interest present in certain New York city pension plan boards of trustees).

53. Local investment is a specific example of the more general problem of social investment by pension funds. See Campbell & Josephson, supra note 13, at 43-44 n.5 (defining terms used to describe various nontraditional investment approaches). Social investment by public funds has recently received much scholarly attention. See Campbell & Josephson, supra note 13; Hutchinson & Cole, supra note 42; Langbein & Posner, supra note 26; Schotland, Should Pension Funds be Used to Achieve “Social” Goals?, 119 TR. & EST. Sept. 1980 at 10, Oct. 1980 at 27, Nov. 1980 at 26. This Comment focuses on the problems caused by locally targeted investments because they are the most prevalent form of social investment by public funds. See Murrmann, Shaffer & Wokutch, Social Investing by State Public Employee Pension Funds, 35 LABOR L.J. 360, 364 (1984). Local investment also raises the clearest conflict of interest issues. See Task Force Report, supra note 2, at 192.

54. Task Force Report, supra note 2, at 191-93; L. Kohlmeier, supra note 4, at 47; Campbell & Josephson, supra note 13, at 43-44.


56. Locally targeted investments “raise issues of fiduciary conflicts of interest since many public pension fund trustees are also government officials negotiating in the context of state and municipal budgets.” Campbell & Josephson, supra note 13, at 45. See Langbein & Posner, supra note 26, at 90 (“Even worse effects on diversification would be caused by a decision to concentrate the fund’s assets in one state or region: in Michigan, for example, which has been so hard hit by the near collapse of the domestic automobile industry.”). See generally Murphy, supra note 4, at 219 (“Underdiversification results from sampling error created by the limited number of potential investments and sampling bias caused by financially comparable social investing criteria that exclude a disproportionate number of investments in large firms concentrated in particular regions and industries.”).

57. Transactions costs are increased by the need to determine and monitor the needs of the local community. See Langbein & Posner, supra note 26, at 93 (socially conscious investor incurs costs of security analysis and trading); Murphy, supra note 4, at 219 (transactions costs increase “because of a need to anticipate and respond to changing corporate policies and changing perceptions of social welfare”).
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tax exempt, however, and are therefore accepting lower returns with no corresponding benefit.59 Fourth, to the extent that public pension plans are willing to invest in local enterprise, the market may not adjust returns to reflect investment risks.60 Thus, although local investments may serve an arguably legitimate political purpose, they generally either subject fund participants to additional risk or result in lower returns. Such locally targeted investments arguably may conform to traditional investment theory only if they produce non-financial collateral returns to public fund participants that compensate for their financial losses.61

A collateral benefit justification for local investment has obvious

59. Investment in municipal bonds is the classic conflict facing public pension funds. See, e.g., Task Force Report, supra note 2, at 193 (investment in munipals violates fiduciary duties); R. Tilove, supra note 34, at 217 (1976) ("There is near universal agreement among knowledgeable observers that it is inherently imprudent for a tax-exempt governmental pension plan to invest in tax-exempt state and local government securities."). Yet from 1975-76, local pension fund investment in state and local government securities rose from 2.2 to 7.5%, and state pension fund investment rose from .7 to 1.4%. This trend was continuing in 1978. The percentage of local investment varies between plans. Many local New York plans have more than a 35% investment in municipal bonds. Task Force Report, supra note 2, at 133-35. In Revere, Massachusetts, the local plan invested 59% of its assets in municipal bonds. Id. at 193. In 1975-76, 2.8% of all assets held in public plans were invested in state and local government securities. Id. at 134. Reluctance to divest municipal bonds may reflect a hesitancy either to suffer book losses or to weaken the market for the municipal bonds. See L. Kohlmeier, supra note 4, at 47. Although it is argued that investment in municipal bonds indirectly benefits participants, "in practice, however, the funds' investments in the obligators of their own states or municipalities do not seem to have been made for any high public or social purpose." Id. at 45. Investments in employer-sponsored securities pose conflicts problems for private funds as well. See generally Herbert, supra note 4. The difference is that the tax-exempt problem does not exist for private plans.

60. For example, between 1980 and 1982, at least 10 states invested in privately-insured, mortgage-backed securities that were significantly riskier and less liquid than the federal government's insured "Ginnie Maes," at yields that were generally below the Ginnie Mae rate. Hearings, supra note 3, at 60. Because the public plan was willing to purchase the securities, the market did not adjust the yield to reflect the higher risk. See Murphy, supra note 4, at 219; Fiscal Distress, supra note 13, at 1008-09. Problems with local mortgages are often correlated with problems with municipal bonds. This suggests that local mortgage investments, like municipal bond investments, are authorized "as much for the benefit of local construction industries, lending institutions and home buyers as for pension fund beneficiaries." L. Kohlmeier, supra note 4, at 47. "When local yields are not so high as those obtainable elsewhere, it makes no sense for a legislature to limit mortgage acquisitions to a pension fund's home state or city." Id. at 48. For other issues raised by investment in local mortgages, see L. Kohlmeier, supra note 4, at 48-49; Campbell & Josephson, supra note 13, at 109-113; Murphy, supra note 4, at 223-24.

61. Collateral returns for participants from locally targeted investments might include increased city services, new jobs, lower taxes or increased job security. See Murphy, supra note 4, at 221. But see Campbell & Josephson, supra note 13, at 47 (collateral benefits cannot justify imprudent investments under current law); Langbein & Posner, supra note 26, at 95-96 (collateral benefit justification is not possible where participants do not choose investments). Cf. Murphy, supra note 4, at 223 ("a strong policy argument can be made that workers should not be able to trade a portion of their future retirement income for present collateral returns.").
problems.\textsuperscript{62} The cost attendant to determinations of collateral benefits makes their consideration administratively infeasible for plan trustees.\textsuperscript{63} Moreover, it is questionable whether the public pension trust is the proper vehicle for these types of policy decisions.\textsuperscript{64} Collateral benefits received through political investments may also benefit some members of the fund at the expense of others. For example, increased employment security would provide a collateral benefit to workers without providing any corresponding benefit to retirees.\textsuperscript{65} These problems have led commentators to conclude that collateral goals should be pursued only to the extent that investments result in a diversified portfolio which earns a return equal to that of a non-politically motivated investment portfolio at the same risk level with no significant additional cost to the fund.\textsuperscript{66}

Potential conflicts also face public pension fund trustees in their choice of service providers.\textsuperscript{67} Pressures exist for public plans to use local service providers, even though better or lower-cost service

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\textsuperscript{62} See Campbell & Josephson, \textit{supra} note 13, at 47; Langbein & Posner, \textit{supra} note 26, at 99; Murphy, \textit{supra} note 4, at 222.

\textsuperscript{63} The fund manager needs a system for quantifying collateral benefits, determining the values each participant places on the collateral benefits and reconciling the differences among values. . . . Costs attendant to making, reviewing and modifying these determinations render social welfare maximization through fund management administratively infeasible. Murphy, \textit{supra} note 4, at 222.

\textsuperscript{64} The argument has been made that because it is taxpayers who ultimately bear the costs of providing public pension funds, collateral benefit justifications for locally targeted investments should be permitted. This is incorrect for two reasons. First, pension benefits are equivalent to deferred compensation. Therefore, public pension funds are held in trust for participants and the needs of taxpayers are irrelevant. See infra note 74 and accompanying text. Second, even if the needs of taxpayers are to be taken into account, it is not in their best interest for public pension funds to select locally targeted investments which increase risk or lower return for the fund, resulting in higher funding needs which must be met through taxation. It would be better for taxpayers if social policies were accomplished directly through the political process in which they have a direct say. It is not the function of public pension trustees to make policy decisions concerning which social goals are to be pursued with taxpayers' dollars. Murphy, \textit{supra} note 4, at 225-27.

\textsuperscript{65} Murphy, \textit{supra} note 4, at 222-23.

\textsuperscript{66} See Campbell & Josephson, \textit{supra} note 13, at 47; Langbein & Posner, \textit{supra} note 26, at 94-95; Murphy, \textit{supra} note 4, at 227. But see A. Scott, \textit{supra} note 24, at § 227.17 (Supp. 1985); Ravikoff & Curzan, \textit{supra} note 26, at 526 n.28; Fiscal Distress, \textit{supra} note 13, at 1010. This does not mean that social benefits cannot be considered at all. "[I]n considering two prudent investments of equal financial merit, trustees should be able to choose the investment offering the more desirable indirect benefits to the pension fund or the greater benefit to the participants community." Campbell & Josephson, \textit{supra} note 13, at 47. See also Murphy, \textit{supra} note 4, at 218. But see Langbein & Posner, \textit{supra} note 26, at 93. For a comparison of the practical problems of considering collateral benefits in defined benefit versus defined contribution plans, see Murphy, \textit{supra} note 4, at 221 n.32, 223 n.37.

\textsuperscript{67} Public fund investment in common stock has increased conflict of interest problems involving the allocation of brokerage commissions, the payment of fees for investment advice and the selection of outside investment managers. See L. Kohlmeier,
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providers are available elsewhere. To the extent that the use of local service providers results in higher administrative costs to the fund, this harms fund participants and their beneficiaries. Yet state regulation fails to guard against such a result. In fact, in many states, statutory or common law provisions mandate the use of local service providers or investments. These statutes are promulgated by state representatives who may benefit from the use of local investment and service providers. To the extent that state regulation fails to prevent conflicts which result in politically motivated investment policies, public plan trustees face an increased risk of never receiving their promised benefits.

2. Investment Standards

State regulation of public fund trustee investment takes two forms: first, a broad definition of a generally acceptable standard for investment conduct, and second, specific restrictions on investment choices. The latter include both legal list statutes enumerating all permissible investments, and statutes limiting fund purchase of certain types of investments to a given percentage of total fund investment. Most states attempt to regulate investment decisions with a combination of specific investment restrictions and general fiduciary duties imposed either by common law or statute. Such a regulatory combination was evident in Withers. Over-reliance on legal lists, however, may cause state laws establishing general fiduciary duties imposed either by common law or statute.

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68. A recent study of the conflict of interest problems in public funds states:

One of the most persistent conflict-of-interest situations in the management of public pension funds results from the policy, followed by many funds, of hiring local bankers, brokers, and investment advisors and the practice of investing in local securities, even though better—or lower cost—services and higher yielding investments may well be available outside local boundaries.

L. Kohlmeier, supra note 3, at 23.

69. A 1978 Pension Task Force Survey discovered that approximately one-fifth of large public pension systems are limited by statute or policy to selecting only investment advisors with in-state offices. Two-thirds of all government plans are required to use in-state brokerage firms to execute trades. More than half of large public systems are required to select local asset custodians. Task Force Report, supra note 2, at 191. See also Hearings, supra note 3, at 103 (statement of the American Federation of State, County and Municipal Employees); L. Kohlmeier, supra note 4, at 23.

70. When assets are managed or invested for any purpose, no matter how meritorious in terms of general social policy, other than to benefit the participants of the pension plan the legitimate interests of the plan participants are jeopardized.

Task Force Report, supra note 2, at 192.

71. The following chart outlines the extent of current state regulation of public pension plans:
ary duties to be less specific than desirable.\textsuperscript{72}

\textit{\textbf{a. General Duties}}

State regulations governing public plans were developed at a time when pension benefits for public employees were considered gratuities conferred by state or local governments.\textsuperscript{73} It is now generally

\begin{center}
\textit{Legal limitations on pension fund investments, 1983}
\end{center}

\begin{tabular}{ll}
\textbf{PRUDENT MAN ONLY—6 STATES} & \\
Delaware & Indiana Teachers Retirement System \\
Idaho & Nevada \\
Maine & South Dakota \\
\hline
\textbf{PRUDENT MAN WITH RESTRICTIONS—31 STATES} & \\
Alaska & Nebraska \\
Arizona & New Hampshire \\
Arkansas & New Jersey \\
California & New Mexico \\
Colorado & New York \\
Connecticut & Ohio \\
Hawaii & Oregon \\
Illinois & Pennsylvania \\
Indiana Public Employees & Rhode Island \\
Kansas & Texas \\
Kentucky & Utah \\
Massachusetts & Vermont \\
Michigan & Virginia \\
Minnesota & Washington \\
Mississippi & West Virginia \\
Missouri & \\
\hline
\textbf{LEGAL LISTS ONLY — 13 STATES} & \\
Alabama & North Carolina \\
Florida & North Dakota \\
Georgia & Oklahoma \\
Iowa & South Carolina \\
Louisiana & Tennessee \\
Maryland & Wisconsin \\
Montana & \\
\hline
\textbf{NO STATUTORY RESTRICTIONS—1 STATE} & \\
Wyoming & \\
\end{tabular}


\textsuperscript{73} \textit{Hearings}, supra note 3, at 57 (statement of Alicia H. Munnel, Vice President and Economist, Federal Reserve Bank of Boston). \textit{See also} Task Force Report, supra note 2, at 4 (public plan trustees generally are confronted either with no statutory guidance or with a confusing maze of laws "leading to conflicts, confusion, and the inadequate allocation of fiduciary responsibilities"); \textit{Id.} at 186 (public fund trustee stating that Alabama has "absolutely no policy guidelines for the person in my position").

\textsuperscript{74} \textit{See} Task Force Report, supra note 2, at 8; L. Kohlmeier, \textit{supra} note 4, at 5. \textit{See also} Murphy, \textit{supra} note 4, at 258 n.205 (recent cases holding public employee pensions to be gratuities); \textit{Fiscal Distress}, supra note 13, at 994-97 (discussing cases holding pensions to be gratuities).
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recognized, however, that pensions are not mere gratuities; rather, they are a form of deferred compensation earned by the employee while he is working and held in trust for him by the employer until retirement.\textsuperscript{74} With the recognition that pension funds are trusts has come a general agreement that those who control public pension plan assets should act as fiduciaries for plan participants.\textsuperscript{75} Neither state law nor most plans, however, adequately define what duties are created by this fiduciary status.\textsuperscript{76}

The common law standard of prudence requires that trustees, in making their investment decisions, "observe how men of prudence, discretion and intelligence manage their own affairs."\textsuperscript{77} Under this standard, the safety of the corpus of the trust should be the primary consideration of the trustee in making investment decisions.\textsuperscript{78} The trustee, however, must also procure a reasonable income on trust assets.\textsuperscript{79} In analyzing individual investment decisions by trustees,?

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\textsuperscript{74} To the extent that employees forgo higher wage levels or make mandatory contributions to a retirement plan fund in exchange for income during their retirement years, employer retirement programs serve as a means of deferring wages. Murphy, supra note 4, at 214. \textit{See also} H.R. 5143, 98th Cong., 2d Sess. § 2(a) (1984) (pension rights are in the nature of property rights); Task Force Report, supra note 2, at 8-9 (trend is toward viewing public pensions as property or contract interests); Hearings, supra note 3, at 83, 92 (assets of pension fund "belong to participants"); \textit{Id.} at 154 (absent pension increases salary increases would be expected); L. Kohlmeier, supra note 4, at 16 (funding of public plans important because it indicates acceptance of the principle that pension funds are deferred wages); Fiscal Distress, supra note 13, at 1010 ("The more reasonable view is that pensions are deferred compensation"). In the pension context, the legislature purports to confer a present benefit in the form of a current promise of deferred compensation. The employee forsakes the opportunity to earn a pension with a different employer in reliance on this promise. \textit{See Fiscal Distress, supra note 13, at 997 n.37 (comparing social security to public pension plans). The hesitancy of some courts to recognize a participant's interest in receiving his benefits stems from a desire to allow the legislature flexibility to adjust pension benefits. Fiscal Distress, supra note 13, at 994 (courts must balance conflicting interests of employee and state). These concerns have led to the suggestion that courts should apply a property analysis which focuses on the employee's reasonable expectation of his pension benefits. \textit{Id.} at 1003. \textit{See also} Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 41 N.J. 391, 197 A.2d 169 (1964) (employee has property interest in public pension fund). \textit{See generally Fiscal Distress, supra note 13, (comparing property, contract and gratuity characterizations of public funds).}

\textsuperscript{75} \textit{See Task Force Report, supra note 2, at 183; L. Kohlmeier, supra note 4, at 16.}

\textsuperscript{76} \textit{See Task Force Report, supra note 2, at 4-5, 188-190.}

\textsuperscript{77} Harvard College v. Armory, 26 Mass. (9 Pick) 446 (1830). A trustee is generally required to exercise the skill of a reasonably prudent person making investment decisions. A. Scott, supra note 24, § 227.2 at 1811. An above-average investor is required to exercise his above-average skill. \textit{Id.; Campbell & Josephson, supra note 13, at 103.}

\textsuperscript{78} \textit{See T. Bleakney, supra note 6, at 141 ("statutory restrictions generally have the purpose of protecting the principal"); A. Scott, supra note 24, § 227.3 at 1811 (primary purpose of trustee should be to preserve estate); Campbell & Josephson, supra note 13, at 88 ("safety of the trust corpus is the single most important factor"). Prudence is a matter of trustee conduct rather than investment performance. \textit{Id.} at 50. Higher potential return will not justify imprudent investment conduct. \textit{Id.} at 95.}

\textsuperscript{79} \textit{See A. Scott, supra note 24, § 227.3 at 1811-12; Campbell & Josephson, supra

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the common law requires both that each investment be prudent, and that the trustee do a careful investigation of the asset prior to purchase. In this way, the common law prudence standard severely limits the ability of the trustee to maintain an economically efficient portfolio of assets for the fund.

Any investment has two elements: risk and return. Investors are assumed to be risk averse; that is, if two investments have the same expected return, the investor will choose the investment with the lower risk. Therefore, the risk averse investor will be willing to pay more for an investment with less risk—the higher the relevant risk of an investment, the higher its returns must be to attract the risk averse investor.

Not all risk is relevant to the investment decision, however. Risk is of two types: systematic and unsystematic risk. Unsystematic risk is that risk which can be eliminated by carrying a diversified portfolio of assets. Because the risk can be eliminated by diversification, it is not compensated for by higher returns in the market. The only risk which is compensated is systematic risk. Systematic risk is compensated because it is correlated with market performance and so cannot be eliminated by diversification. The only risk relevant to the investment decision, therefore, should be systematic risk.

The common law standard of prudence requires that each individual investment be prudent. Yet the addition of risky investments to a diversified portfolio may reduce the systematic risk of the portfolio. Therefore, by not permitting the trustee to make any risky investments, the common law standard may result in the public pen-

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note 13, at 92 (standard applied in New York demands either reasonable and regular amount of income or that level of income which will not require trustee to incur undue risks).

80. See supra note 33 and accompanying text.
81. See Campbell & Josephson, supra note 13, at 104. See also Donovan v. Bierwirth, 680 F.2d 263 at 276. (neither prudence nor good faith will insulate ERISA trustee who fails to properly investigate investment prior to purchase).
83. Id.; Langbein & Posner, supra note 26, at 78.
84. See R. Brealy & S. Myers, supra note 82, at 129; Langbein & Posner, supra note 26, at 79.
85. See R. Brealy & S. Myers, supra note 82, at 125 n.12; Langbein & Posner, supra note 26, at 79.
86. See Langbein & Posner, supra note 26, at 80.
87. Id.
88. See supra note 33 and accompanying text.
89. A stock may have a high over-all risk and a low systematic risk. Langbein & Posner, Market Funds and Trust Investment Law, 1976 A.B.A. Found. Res. J. 1, 18 [hereinafter cited as Market Funds]. Moreover, where the risks of two stocks are reciprocal, they will cancel out and lower overall portfolio risk. Id. at 8. See also R. Brealy & S. Myers, supra note 82, at 144. See also Market Funds, supra, at 17 (no advantage to fund from elimination from portfolio of “bad” stocks).
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dition fund carrying a less than optimal portfolio because the fund is forced to carry risk uncompensated by the market.90 Because pension plan participants are risk averse, they are harmed by this regulatory structure.91 Concern over this has led to the current proposals for federal regulation of public pension plans which seek to abolish prudence requirements for individual investments.92

Another problem with relying on the common law standard of prudence is its uncertain applicability to public pension funds.93 In cases where the common law standard has been applied to public pension fund trustees, the statutes establishing the fund employed traditional trust language to describe the relationship between the members of the board and plan participants.94 Many public funds do not use traditional trust language, however, and it remains unclear whether, without statutory language indicating a traditional trust relationship, the common law of trusts is applicable.95

State statutes have failed to resolve the problems created by common law doctrines. State statutes which create or regulate public plans rarely articulate appropriate general guidelines for the fiduciary responsibilities of trustees.96 They denote neither who within the structure of the public plan is to be held accountable, nor the substance of relevant fiduciary responsibilities.97 In cases of trustee abuse, therefore, the absence of a codified, substantive standard of conduct to which the fiduciary can be held, whether derived from statutory regulations, common law or the plan itself, frequently precludes recovery by plan participants.98

b. Investment Restrictions

Most states also have statutes which limit the investment choices

90. See Campbell & Josephson, supra note 13, at 97; Langbein & Posner, supra note 26, at 79.
91. Because the fund could earn the same return at a lower risk through diversification, a regulatory structure which limits diversification forces the fund to incur risk without compensation. For this reason, risk averse plan participants who prefer their plans to bear no uncompensated risk are harmed by the current regulatory structure. Financial theorists assume that investors are risk averse. See, e.g., Langbein & Posner, supra note 26, at 78 (“economic theory implies and empirical study confirms that investors are generally risk adverse”).
92. See infra notes 203-205 and accompanying text.
93. Liebeg & Kolman, supra note 22, at 25. See also Herbert, supra note 4, at 146 (discussing this problem in context of private trusts).
95. Liebeg & Kolman, supra note 22, at 25.
96. TASK FORCE REPORT, supra note 2, at 71, 188.
97. Id. at 3.
98. Id. at 189.
available to public plan trustees. For example, trustee investment in common stock is generally limited to a specified percentage of the plan’s portfolio. Many states further limit public fund trustees by promulgating specific “legal lists” of permissible investments. In these states, the legislature takes a more active role in structuring the fund portfolio by circumscribing the role of the plan trustee to choosing from among a predetermined set of statutorily acceptable investments. Even when selecting from the “legal list,” however, the trustee may remain bound to general fiduciary responsibilities.

The problem with specific investment limits is that they overly restrict public pension plan trustees. By limiting the field of permissible investment choices, they may result in an underdiversified portfolio bearing uncompensated risk. Moreover, the legislature is not the proper determinant of investment strategies for public pension plans. First, legislatures have an overt political interest in promoting local investment to the detriment of plan participants. Second, each public plan has different investment needs determined by its size, its time focus, and the structure of its workforce. It is therefore not clear that the legislature could promulgate a list of investments which would be both broad enough to encompass the needs of all plans and limited enough to ensure a prudent portfolio.

II. Arguments for Reform

The Employment Retirement Income Security Act of 1974 (ERISA) restructured the regulation of private pension plans. ERISA sought to establish a coordinated federal regulatory framework to

99. Id. at 194-95.
100. Approximately 10% of the public pension plans in a recent Congressional study were prohibited from investing in common stock. In 60% of the surveyed plans, common stock investment was limited to 35% or less, and only 7% of the surveyed plans were completely free of restrictions regarding investment in common stock. Task Force Report, supra note 2, at 132. See also L. Kohlmeier, supra note 4, at 29.
101. Task Force Report, supra note 2, at 194. See also Campbell & Josephson, supra note 13, at 53 (“Ironically, the original purpose of the legal list was to liberalize the scope of investments the trustee could consider.”); Murphy, supra note 4, at 238 n.102.
102. Campbell & Josephson, supra note 13, at 54 (trustees must exercise duty of care and skill in choosing among authorized investments).
103. See Campbell & Josephson, supra note 13, at 115-16; Murphy, supra note 4, at 236 (“mandated investment restrictions . . . produce inherent inefficiencies and poor investment results”).
104. See supra notes 85-87 and accompanying text. These problems have led some states to drop or expand legal list statutes. See Campbell & Josephson, supra note 13, at 115 n.384.
105. See supra note 42 and accompanying text.
106. See infra note 208 and accompanying text.
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achieve increased retirement security for the private sector labor force.\textsuperscript{108} Prior to the passage of ERISA, private plans were subject only to state and local regulations which often failed to insure investment security.\textsuperscript{109} ERISA enacted a coordinated set of regulations which establish fiduciary, funding, reporting and disclosure standards for private plans.\textsuperscript{110}

When ERISA was drafted, public pension plans were covered by its proposals.\textsuperscript{111} Public plans were subsequently removed from ERISA's scope because of both a lack of information about public plans and doubts about the constitutional validity of federal regulation of state and local funds.\textsuperscript{112} ERISA did, however, mandate an extensive study of the viability of public plans and the possible need for future federal regulation.\textsuperscript{113} This comprehensive study of public plans, the first of its kind, determined that serious deficiencies existed at all levels of public plans in reporting, disclosure, funding and fiduciary responsibilities.\textsuperscript{114} It concluded that federal regulation was both constitutionally permissible\textsuperscript{115} and institutionally desirable.\textsuperscript{116} This section of the Comment will further consider both of these conclusions.

A. Constitutionality

The primary constitutional basis of federal regulation of public funds is the Commerce Clause.\textsuperscript{117} Congress, pursuant to the Commerce Clause, is given the power to regulate interstate commerce. To determine whether an activity involves interstate commerce, a simple test is applied: "...whether the activity sought to be regulated is 'Commerce which concerns more states than one' and has a

\textsuperscript{108} Senate Special Comm. on Aging, 98th Cong., 2d Sess., The Employee Retirement Income Security Act of 1974: The First Decade 28 (Senate Print 98-221 1984) [hereinafter cited as The First Decade].
\textsuperscript{109} Id. at 27 (although some federal regulation did exist prior to ERISA in tax, labor, and criminal law, both the specific federal regulations and the more general state regulations were generally viewed as ineffective).
\textsuperscript{110} Id. at 28.
\textsuperscript{111} See Task Force Report, supra note 2, at 1; Hearings, supra note 3, at 57 (statement of Alicia H. Munnell, Vice President and Economist, Federal Reserve Bank of Boston).
\textsuperscript{112} Id. See also Campbell & Josephson, supra note 13, at 66-67; Fiscal Distress, supra note 13, at 992 n.3, 1017.
\textsuperscript{114} Task Force Report, supra note 2, at 1-5.
\textsuperscript{115} Id. at 17-22.
\textsuperscript{116} Id. at 49.
\textsuperscript{117} U.S. Const. art. I, § 8, cl. 3. See Task Force Report, supra note 2, at 17.

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real and substantial relation to the national interest."\textsuperscript{118} 

Applying this test to public pension funds, it is clear that the regulation of public funds falls within the Commerce Clause power. As stated by the 1978 Congressional Task Force Report on public funds:

Given the tremendous impact public employee retirement systems have on the securities markets and the national economy, the frequent movement between various states of public plan participants, and numerous other factors all demonstrating that public employee retirement systems involve more than the state in which the plan is located, it is clear that public plans involve interstate commerce, and hence may be regulated by Congress under its Commerce Clause.\textsuperscript{119}

The extent of Congress' Commerce Clause powers, however, may be limited by federalism concerns. At the time this study was made, \textit{National League of Cities v. Usery}\textsuperscript{120} articulated the prevailing constitutional standard for determining those powers reserved by the Constitution exclusively to the states. \textit{National League of Cities} held that the Constitution did not empower Congress to regulate in "areas of traditional governmental functions."\textsuperscript{121} Many legislators thought that public fund regulation was the sort of "traditional government function" reserved exclusively to the states.\textsuperscript{122} Whatever the validity of this conclusion at the time, the issue of the legitimacy of federal public fund regulation under \textit{National League of Cities} is purely an academic question today. In \textit{Garcia v. San Antonio Metropolitan Transit Authority},\textsuperscript{123} the Court overruled \textit{National League of Cities}, holding that the states' continued role in the federal system is guaranteed by the structure of the federal government itself rather than by any externally imposed limits on the Commerce power.

Under this process notion of federalism, "Any substantive restraint on the exercise of Commerce Clause powers must find its justification in the procedural nature of this basic limitation, and it must be tailored to compensate for possible failings in the national political process rather than to dictate a 'sacred province of state autonomy.'"\textsuperscript{124} The procedural focus of the \textit{Garcia} standard re-

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\textsuperscript{118} Heart of Atlanta Motel v. United States, 379 U.S. 241, 255 (1964).
\textsuperscript{119} TASK FORCE REPORT, supra note 2, at 18.
\textsuperscript{120} 426 U.S. 833 (1976).
\textsuperscript{121} Id. at 852.
\textsuperscript{122} See H.R. REP. No. 1139, 98th Cong., 2d Sess 85 (1984) (dissenting views of Hon. Steve Bartlett); \textit{Hearings, supra} note 3, at 57 (statement of Alicia H. Munnel, Vice President and Economist, Federal Reserve Bank of Boston); \textit{State Groups Oppose ERISA Legislation}, \textit{Tax Notes} April 5, 1982 at 95.
\textsuperscript{123} 105 S.Ct. 1005 (1985).
\textsuperscript{124} Id. at 1019-1020 (quoting \textit{EEOC v. Wyoming}, 460 U.S. 226, 236 (1983)).
\end{flushleft}
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quires a determination that the "internal safeguards of the political process have performed as intended." There can be no question that this is the case with respect to the current proposal for federal regulation of public pension plans. Congress has been considering the desirability of such regulation for over ten years. Extensive studies and hearings have been conducted by Congress at which representatives of the states were encouraged to voice their protests to such regulation. Congressional approval would, therefore, mark the final step in an ongoing and regular national political process.

The constitutional validity of the proposed federal pension fund regulation is further demonstrated by the fact that it is less intrusive on state sovereignty than the minimum wage requirements approved by Garcia. In Garcia, the Court held that a local public transit authority was not immune from the minimum wage and overtime requirements of the Fair Labor Standards Act because there was nothing in those requirements that was "destructive of state sovereignty or violative of any constitutional provision." In so holding, the Court reasoned that the wage standards imposed on state employers were no more extensive than those required of private firms. The Court looked to the fact that the federal government provides financial assistance to state and local mass transit systems to further rationalize the expense imposed on the states by the minimum wage requirements.

Similarly, the federal regulation of public pension funds proposed by this Comment is less extensive than that applied to private plans by ERISA. The only expense to the states may be an increase in administrative costs. These expenses can be justified by the fact that the federal government provides assistance to public plans by

125. Id. at 1020.
126. See, e.g., Task Force Report, supra note 2, at 1; Hearings, supra note 3, at 3 (statement of Hon. Killean Townsend, Georgia State Representative on behalf of the National Conference of State Legislators).
127. 105 S.Ct. at 1020.
128. Id.
129. Id.
130. See H.R. Rep. No. 1139, 98th Cong., 2d Sess. 44 (1984). Neither this Comment nor PEPPRA addresses the funding problems which plague public plans. This would be the most fertile ground for constitutional objection. See Task Force Report, supra note 2, at 19. However, under the standard articulated in Garcia, federal regulation of the funding of public plans would seemingly be constitutional.
131. It is not clear that the proposed federal regulation would be more costly than the regulatory schemes already in place in most states. See supra note 71 and accompanying text.
exempting them from federal income tax assessments.\(^{132}\) For these reasons, federal regulation of public pension plans would be constitutionally permissible under the *Garcia* standard.

**B. Institutional Desirability**

The primary question considered by this Comment is the desirability of federal regulation of public plan trustees. This section addresses two issues. First, is *any* regulation of public fund trustees necessary? Second, if some regulation is desirable, why is the federal, rather than the state, government the appropriate regulator?

1. **The Need for Regulation**

Participants in pension plans have an interest in the proceeds from fund assets which is akin to ownership.\(^{133}\) This is true for public as well as private employees. The management and control of fund assets, however, is vested in trustees whose interest in fund proceeds is slight when compared with the gains they could appropriate by diverting fund assets to their personal or professional use.\(^{134}\) An incentive structure, either market or regulatory, is thus necessary to ensure that such diversion does not occur.\(^{135}\)

In the context of the modern corporation three mechanisms exist for aligning the interests of the corporation’s owners, its shareholders, with those of its managers: the market for managerial expertise, the market for corporate control, and formal voting requirements.\(^{136}\) Common stockholders own claims on the corporation which are freely alienable.\(^{137}\) An efficient market exists to value their claims at a low cost;\(^{138}\) the value of a claim reflects investors’ opinions as to the implication of managerial decisions on current and future cash flows.\(^{139}\) This has two results. First, a lower price will reflect poorly on the manager’s skill, thus lowering his ability to compete for future managerial positions.\(^{140}\) Second, a depressed

\(^{132}\) See *supra* notes 14-21 and accompanying text.

\(^{133}\) See *supra* note 74 and accompanying text.


\(^{135}\) See generally Fama & Jensen, *supra* note 1, at 304.

\(^{136}\) See *id.* at 312-15.

\(^{137}\) See *id.* at 313.


\(^{139}\) See Fama & Jensen, *supra* note 1, at 313.

\(^{140}\) See also Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Governance*, 84 Colum. L. Rev. 1145, 1234-38 (1984); Vagts, *Chal-
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stock price makes a company a likely target in the takeover market. Managers who wish either to enhance their own marketability or to retain control are thus encouraged to maintain stock prices. Since stock prices are maximized by maximizing returns while minimizing risk, exactly the policy desired by the corporation's owners, both the market for managerial expertise and the market for corporate control serve to align manager and shareholder interests. Finally, through their right to approve the membership of the board of directors, shareholders retain at least a modicum of formal control over management.

Unlike common shareholders, public pension plan participants remain unprotected by market mechanisms. As do common shareholders, public fund participants own financial interests in whose management they do not participate. An essential difference between shareholders and fund participants, however, is that public fund participants' ownership rights are usually not alienable. There is no market (much less an efficient market) for pension fund benefits for the simple reason that it is generally impossible to transfer benefits between individuals. Without a direct mechanism for pricing pension benefits to reflect the impact of trustee decisions on risk and return, there cannot exist an external monitoring of trustees analogous to that provided common shareholders through either the market for managerial expertise or the takeover market.

The possibility remains, however, that pension plan benefits might be priced indirectly through their effect on the wages public employers must pay to attract employees. Given a limited labor force, to the extent public employers compete among themselves and with the private sector for employees, there should exist a mar-

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141. See Fama & Jensen, supra note 1, at 313.
142. See id.
143. See id.
144. Vested pension benefits may generally either be transferred or divested upon termination of employment. See R. Tilove, supra note 34, at 192-193. Pension benefits are tied to a particular individual, however, and ordinarily cannot be transferred between individuals. See also H. Rubin, Pensions and Employee Mobility in the Public Sector 9-19 (1965); R. Tilove, supra note 34 at 20-28 (1959). The same is true for private pension benefits. See generally Task Force Report, supra note 2, at 87-92.
145. All market mechanisms for monitoring corporate managers are tied to stock price. See Fama & Jensen, supra note 1, at 312-13. If corporate shares were not transferable, market mechanisms would break down. Another means of monitoring corporate managers involves the use of contract incentives. Such incentives are infeasible for public trustees who are either uncompensated or pursue goals which are not easily quantifiable. See R. Tilove, supra note 34, at 215; Murphy, supra note 4, at 246 n.153. See also Herbert, supra note 4, at 146, 159.
ket for employees in which competition insures that each employee receives the maximum compensation package possible. Assuming that any package can be divided into pension benefits and wages, if public pension plans are managed inefficiently, public employers should be forced to offer larger wages to compensate for the reduction in pension benefits. Under this scenario, the wage level offered to new employees would reflect the impact of trustee decisions.146

A number of factors may explain why such a result has never obtained. First, over the relevant past, there has been significant unemployment.147 The supply of labor has, therefore, exceeded demand. Assuming that a more than adequate number of qualified employees have existed for public sector jobs, there has been little incentive for employers to maximize compensation packages. Second, workers tend to have optimistic views of management. "They are taken in by vague assurances of good faith, by legally unenforceable promises and by their own hopes for the good life. Tough minded bargaining in its entirety never occurs—or if it occurs, it comes too late."148 Thus, even if effective competition among employers were to exist, prospective employees might not demand the maximum compensation obtainable. Third, until relatively recently, pensions were considered gratuities rather than part of a compensation package.149 Fourth, public employees are not guaranteed the right to collective bargaining.150 Finally, even if present employees were able to glean information about trustee activity from the compensation offered new employees, they might be unable to act on the information. Dissatisfied fund participants have little leverage over their employers because previously earned benefits may be lost if they carry out their ultimate threat by "voting with their feet" and leave their jobs.151

146. See Hearings, supra note 3, at 154 (statement of Gerald W. McEntee discussing tradeoff between wages and pension benefits); Fiscal Distress, supra note 15, at 1010 n.109 (discussing tradeoff between compensation and pension benefits).


148. O. Williamson, The Economic Institutions of Capitalism 38 (1985). The dangers of risky investments are not generally perceived by the beneficiaries of the plan. Although participants often challenge the amount of benefits, they rarely question the existence of the benefits. See Herbert, supra note 4, at 136.

149. See supra note 73 and accompanying text.


151. Although participants have the option of leaving their employment, exercise of the option will often result in pension forfeiture unless pension benefits have vested.
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With respect to formal control of trustees, a public plan's board of trustees does not represent fund participants in the same way that the board of directors of a corporation represents the shareholders. The trustees of public funds are generally appointed by, and answer to, the political process rather than plan participants. The protection provided common shareholders by their ability to disapprove a board of directors is thus denied public pension fund participants.

Public pension participants may be represented by union officials, however. The question remains why the unions have not pushed either for tougher regulation of public pension fund trustees or for more efficient management of public pension funds. A number of factors may explain this phenomenon. Union officials often sit on pension fund boards as employee representatives. To the extent that the interests of union officials diverge from those of plan participants, it is in the officials' interest to maintain a loose regulatory structure. Moreover, to the extent that employees remain unconcerned with pension fund management, union officials will maximize their popularity with their constituents by concentrating their efforts on wages when negotiating a compensation package. Finally, public pension funds are not subject to collective bargaining in many states.

The above discussion has made clear that public pension plan participants currently have no means of adequately monitoring their trustees. If the interests of plan trustees were no different from those of plan participants, this would be of little concern. However, the interests of public pension plan trustees differ from those of plan participants in a number of important ways. First, the trustee's ability to expropriate fund assets for her personal gain may result in harm to fund participants. Absent regulation, for instance, the

Moreover, changing employment may adversely affect even vested rights to pensions. See supra note 144 and accompanying text. See generally H. Rubin, supra note 144, at 15-18.

152. See supra note 42 and accompanying text.

153. See Campbell & Josephson, supra note 13, at 70.

154. For an example of the divergence between union and employee interests, see Blankenship v. Boyle, 329 F. Supp. 1089 (D.D.C. 1971). Legislative concern at the time the National Labor Relations Act was passed centered on union expropriation of pension funds. See Herbert, supra note 4, at 148. Traditionally, management has cited union diversion of pension benefits in arguing against union control of pension funds. Id. at 136.

155. See supra note 148 and accompanying text.

156. See R. Tloupe, supra note 34, at 353; Murphy, supra note 4, at 214 n.7. Even where plans are the object of collective bargaining, unions will often allow management to control the funds. See Herbert, supra note 4, at 134.

157. See Jensen & Meckling, supra note 134, at 313 (agency conflict derives from
trustee could borrow funds from the trust at a lower than market rate. Because there is no market for pension fund benefits that would reflect the resulting decrease in fund value, the trustee's appropriation could continue unnoticed, and the participant would bear the full costs of the trustee's gains.158

Second, all fixed-benefit pension plan participants face the problem that, to a certain extent, the benefits from investments accrue to the plan sponsor, while the participant bears the risk of large losses.159 This inconsistency arises from the nature of fixed benefit plans which require only that the sponsor pay the amount specified in the pension plan.160 Thus, if the plan earns substantial gains, the sponsor and not the participant keeps the ensuing benefit.161 Moreover, if the sponsor makes risky investments that result in large losses bankrupting the fund, the participant bears the loss.162
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Thus, absent regulation, trustees have an incentive to make risky investments whose gains accrue to the plan's sponsor while plan participants shoulder the risk of loss.

Third, employee representative trustees are generally union officials. Union officials possess distinct interests in maintaining and/or increasing the power of the union and their position within it through the manipulation of fund assets. Moreover, because union officials essentially owe their allegiance only to those currently working, they may bargain for increased wages at the expense of retirement benefits. This harms retirees and those near retirement age.

Finally, state representative trustees' actions are evaluated by a political market while participants remain motivated solely by economic considerations. The nature of the political process, which judges performance at relatively short intervals, encourages trustees who are either elected officials or political appointees to pursue a short term focus of investment yield, maximizing profits over the short rather than the long run. Plan participants, on the other hand, would generally prefer investments which earn the highest rate of return over the long run because they will receive their benefits from the plan only at retirement.

The political investing problem discussed earlier provides another example of the divergence between responses to political and economic markets. To the extent that investment in local assets benefits the state as a whole, trustees will be encouraged to invest in local assets, even though the associated risks are higher or the returns lower, to the detriment of plan participants.

It appears, therefore, that the interests of trustees differ materially from those of plan participants. Given the lack of a market for fund benefits which could serve to align trustee and participant interests, regulation becomes necessary to create incentives for public pen-

Prevented local plans from achieving adequate financing. Moreover, the state may be under no legal obligation to guarantee local plans. Id. Over 80% of public plans are administered at the local level. Id. at 56. This has led some commentators to argue that effective management of pension funds is especially important in the public sector. See Murphy, supra note 4, at 212.

163. See, e.g., Blankenship v. Boyle, 329 F. Supp. 1089 (1971) (union trustees placed substantial assets of pension trust in union-owned bank at no interest and authorized stock purchase which was primarily for union's benefit).

164. See Allied Chemical & Alkali Workers v. Pittsburgh Plate Glass Co., 404 U.S. 154, 173 ("the risk cannot be overlooked that union representatives on occasion might see fit to bargain for improved wages or other conditions favoring active workers at the expense of retirees' benefits").

165. See supra note 42 and accompanying text.

166. See Herbert, supra note 4, at 138-99; Murphy, supra note 4, at 214-15.

167. See supra notes 53-70 and accompanying text.
sion fund trustees to operate their funds in the interests of plan participants.168

2. Federal Regulation vs. State Regulation

Regulation of public pension fund trustees would provide a needed check on the activities of the trustees which the market fails to provide. If regulation is to be an effective check, the regulator should not be the manager of the funds;169 because individuals act opportunistically, regulations promulgated by fund managers could not be expected to limit managerial abuses.170

Public pension funds are operated by state and local governments. State and local government representatives generally act as the fund trustees. The benefits from mismanagement of fund assets, therefore, accrue either to the government entity itself or to the trustee, who is generally a government representative. The states thus have little incentive to promulgate effective regulations because it is in their interest to enable mismanagement by maintaining as much flexibility as possible for the managers of their vast public funds.

Another problem with state regulation is the general hesitancy of one legislature to commit future governments to a particular system of pension fund regulation.171 The result is a lack of a consistent policy framework to guide public pension fund trustees. States’ lack of interest in improvement of public fund regulation is exemplified by the fact that although the current regulatory structure is generally recognized as ineffective, states have done virtually nothing to improve their regulations—any small improvements which have been made have come only in response to the threat of federal regulation.172

The federal government is a superior regulator of public pension

168. See generally Seidman, The Government Corporation: Organization and Controls, 14 Pub. Ad. R. 183, 185 (“The single most critical control point is the law, decree, or other basic authority providing for the creation of a public enterprise.”).
169. The role of a regulatory framework should be to create those conditions that will insure competent management of public funds. Regulations affect the ability and motivation of an organization to perform effectively. See Murphy, supra note 4, at 237.
171. See Task Force Report, supra note 2, at 65; Murphy, supra note 4, at 229.
172. See Hearings, supra note 3, at 103 (statement of American Federation of State, County and Municipal Employees).
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funds for two reasons. First, the federal government does not participate in the management of state and local pension funds. Therefore, Congress does not have the same incentives as state governments to promulgate regulation which serves itself at the expense of plan participants. Moreover, federal regulation should, at least in theory, remain responsive to the needs of both the states who sponsor the funds and plan participants because both are represented in Congress. Neither the states nor individual public employers, however, would generally have sufficient power adversely to influence a federal regulatory process spanning a large number of states and employers.

Second, federal regulation permits uniform standards to be imposed on a national basis. Uniform standards will increase both the efficiency and effectiveness of regulation of public pension fund trustees' fiduciary responsibilities. Uniformity is particularly important with respect to reporting and disclosure requirements.

173. The federal government does administer pension funds for federal employees. Although this Comment does not consider federal pension plans, problems similar to those discussed herein are raised by federal regulation of federal public plans. See Hearings, supra note 3, at 3 (statement of the Hon. Kiliaen Townsend, State Representative, State of Georgia, on behalf of National Conference of State Legislators). See generally The First Decade, supra note 68, at 161-69.

174. One potential objection to federal regulation involves the claim that the federal government lacks the information necessary to properly regulate public pension funds. This objection is more valid in the context of private funds, however, because private plan participants may be more widely dispersed. Private plans are already regulated by the federal government. Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (1982). It is in the interest of public plans to insure that the federal government has the information necessary for regulation. Moreover, informational problems are more pertinent in the context of vesting, portability or funding requirements, none of which are considered either by this Comment or PEPPRA.


176. See Task Force Report, supra note 2, at 4-5 (uniform standard necessary); Hearings, supra note 5, at 102 (statement of American Federation of State, County & Municipal Employees) ("Pension experts uniformly agree that the establishment of uniform fiduciary standards by ERISA has had a major influence on ending pension fund mismanagement."). See also L. Kohlmeier, supra note 4, at 55. The standard imposed by ERISA and PEPPRA is general; it can, therefore, be interpreted by the federal courts to meet the needs of individual cases. See Donovan v. Bierwerth, 680 F.2d 263 (2d Cir. 1982).

177. See Hearings, supra note 3, at 57 (statement of Alicia H. Munnel, Vice President and Economist, Federal Reserve Bank of Boston); H.R. Rep. No. 1139, 98th Cong., 2d Sess. 45 (1984). Current disclosure by public pension funds is inadequate. See Task Force Report, supra note 2, at 79-82. Only a small percentage of public plans could meet a disclosure requirement similar to that of ERISA. Id. at 76. Lack of disclosure reflects a failure by public fund trustees in discharging their fiduciary obligations to plan participants. Id. at 184.
Uniform reporting and disclosure requirements will assist plan participants in more effective monitoring of trustees by enabling comparisons between plans.\textsuperscript{178} Unless reports contain essentially the same data, however, inter-plan comparisons will be difficult, if not impossible, to make.

Congress's most recent proposal for federal regulation of public plans, the "Public Employee Pension Plan Reporting and Accountability Act of 1984" (PEPPRA),\textsuperscript{179} provides an example of a uniform reporting and disclosure requirement. PEPPRA seeks to provide a framework for guaranteeing full disclosure, prudent management and fiscal accountability with respect to public funds.\textsuperscript{180} The proposed Act would give public pension plan participants essentially the same rights as those guaranteed private pension plan participants under ERISA by ensuring trustee fiduciary responsibility and maintaining reporting and disclosure requirements.\textsuperscript{181} The potential benefits from PEPPRA's proposed disclosure requirements are greatly diminished, however, by a provision which permits states with substantially similar disclosure requirements to apply their own standards.\textsuperscript{182} In effect, this allows some state reports to remain noncomparable, and would increase administrative costs by requiring a determination of whether a state provides substantially similar disclosure. To facilitate effective monitoring, the proposed regulation should be amended to require compliance with a single federal standard for reporting and disclosure.\textsuperscript{183}

Finally, the need for federal rather than state regulation of public plans is effectively demonstrated by the abuses which currently plague public plan administration.\textsuperscript{184} The federal government traditionally has allowed state and local governments to regulate public

\textsuperscript{178} Hearings, supra note 3, at 57 (statement of Alicia H. Munnel, Vice President and Economist, Federal Reserve Bank of Boston).

\textsuperscript{179} H.R. 5143, 98th Cong., 2d Sess. § 102 (1984); H.R. 5144, 98th Cong., 2d Sess. § 102 (1984). Two versions of PEPPRA have been proposed to the House of Representatives in two separate bills, H.R. 5143 and H.R. 5144. Both bills are identical in regard to the matters discussed by this Comment. All references, therefore, will be to H.R. 5143.


\textsuperscript{181} See Campbell & Josephson, supra note 13, at 64.

\textsuperscript{182} States are exempted from the federal reporting and disclosure requirements if a state's governor certifies to the Secretary of Labor that state laws are substantially equivalent to PEPPRA's requirements. H.R. 5143, 98th Cong., 2d Sess. § 102 (1984).

\textsuperscript{183} Hearings, supra note 3, at 26 (statement of the American Federation of State, County and Municipal Employees).

\textsuperscript{184} The Hudson County, New Jersey, pension fund was forced into receivership "largely as a result of abuses in the plan's eligibility and disability provisions." TASK FORCE REPORT, supra note 2, at 185. Recently, the governor of California vetoed legislation which would have removed the management of public funds from the political
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This has resulted in a crisis in public plans which threatens the fiscal stability of state and local governments.  

III. Problems Facing Regulators of Public Fund Investment Decisions

This Comment has argued that federal regulation of public plans is necessary to insure that trustees maximize the returns and minimize the risks of fund investments so that plan participants are guaranteed receipt of their earned benefits. This section analyzes one attempt by Congress at implementing such regulation, PEPPRA. It suggests that PEPPRA is correct in eliminating specific limitations on trustee investment choice; trustees must be left free to match risk and return to the needs of their individual plans. However, by eliminating specific investment choice restrictions, not dictating a maximum risk level, and explicitly authorizing the use of trustees with clear conflicts of interest, PEPPRA goes too far—in an attempt to allow flexibility, it leaves participants open to trustee expropriation.

A. Investment Limitations

PEPPRA makes important positive changes to current standards defining public pension fund trustee prudence. PEPPRA relies on a regulatory structure which first defines the duties of trustees in general terms, and then sets forth a number of prohibited transactions.

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arena. See Hearings, supra note 3, at 98, 104 (statement of the American Federation of State, Local and Municipal Employees).
185. See Hearings, supra note 3, at 82, 91 (statement of the American Federation of State, Local and Municipal Employees).
187. See Herbert, supra note 4, at 166 (any regulation must either prohibit conflicts of interest or impose specific investment restrictions).
188. H.R. 5143, 98th Cong., 2d Sess. § 204 (1984) provides that:

... [a] fiduciary shall carry out such fiduciary's functions with respect to a plan solely in the interest of the participants and beneficiaries and—

(1) for the exclusive purpose of—
(A) providing benefits to participants and their beneficiaries; and
(B) defraying reasonable expenses of administering the plan;

(2) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person 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;

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

(4) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this Act.
PEPPRA does not define a list of permissible investments. PEPPRA's general fiduciary standard is identical to that applied to private plans by ERISA. PEPPRA, however, is more lenient than ERISA in defining prohibited transactions. Thus, public trustees are bound by fewer restrictions with respect to individual plan investments than are their private sector counterparts. As long as an investment decision meets PEPPRA's prudence requirements, various innovative investment vehicles such as pooled funds and mortgage-backed securities will be acceptable for public fund investment. The same investment by a private fund trustee would require an administrative exemption. Additional reforms include PEPPRA's increase in the required level of prudence, limitations on investment in employer-sponsored securities, and a diversified portfolio requirement.

Current law defines the duties and responsibilities of public fund trustees in terms of a prudent person or a prudent investor. PEPPRA requires that trustees exert the skill that "a prudent person 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." This language appears to establish the standard of an expert investor of public funds.

PEPPRA also limits the acceptable level of investment in municipal bonds to 5%. This is considerably lower than the percentage allowed by ERISA for private pension investment in assets of the corporation sponsoring the fund. This distinction is necessary because of the explicit costs to the public pension fund of carrying municipal bonds. Moreover, any investment by a pension fund, public or private, in assets of the entity which sponsors it, creates

190. For a discussion of why this is a positive change, see supra notes 103-106 and accompanying text.
194. Id.
195. Id.
197. See Campbell & Josephson, supra note 13, at 66. A more stringent fiduciary obligation should also serve to encourage trustees to seek investment advice or to delegate the investment decision.
200. See Task Force Report, supra note 2, at 193 (inherently imprudent for public funds to carry tax-exempt municipal bonds).
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real conflicts of interest problems. Because it is not clear that any such investment should be permitted, the more stringent the restriction the better.\textsuperscript{201}

PEPPRA also specifically requires that public pension funds carry a diversified portfolio of assets.\textsuperscript{202} This provision will eliminate the risk of large losses when a single investment or group of investments is unsuccessful.\textsuperscript{203} The question remains, however, whether individually risky investments are permissible under PEPPRA. ERISA has been interpreted to preclude insistence by a state that the fund trustee scrutinize the safety of each individual investment rather than judging the performance of the portfolio as a whole.\textsuperscript{204} PEPPRA's requirement is identical to ERISA's; thus it is likely that PEPPRA's standard will be interpreted in the same way as ERISA's.\textsuperscript{205} Under such an interpretation, trustees would be free to maximize the value of the portfolio as a whole even at the cost of investing in an individually risky asset.

Permitting pension funds to make individually risky investments, however, increases the possibility that trustees will make investments that provide collateral benefits to themselves either personally or professionally. Because investments are not individually scrutinized by the legislature or the judiciary, no check on the choice of investment exists so long as the overall portfolio remains sound.\textsuperscript{206} In this way, the trustee's discretion in making investment decisions is enhanced.\textsuperscript{207} Her discretion is further enhanced by PEPPRA's failure to dictate a maximum risk level for the trust portfolio.

Different funds have different capacities to bear risk depending on the nature of their beneficiaries, their size and other factors.\textsuperscript{208}

\textsuperscript{201} See Herbert, supra note 4 (considering similar problems in the context of private plans). Although worded in the negative, this provision could be interpreted to create a presumption in favor of public funds holding up to 5% of their portfolio in employersponsored securities. However, any investment by public pension funds in employersponsored, tax-exempt securities should be forced to meet PEPPRA's general prudence and loyalty requirements. H.R. 5143, 98th Cong., 2d Sess. §§ 204, 206 (1984).


\textsuperscript{203} See Campbell & Josephson, supra note 13, at 96.

\textsuperscript{204} See 29 C.F.R. § 2550.404a-1(b) (1982). See also Campbell & Josephson, supra note 13, at 97.

\textsuperscript{205} Campbell & Josephson, supra note 13, at 65.

\textsuperscript{206} See Herbert, supra note 4, at 146, 159 (when employer-sponsor manages trust, application of flexible prudence standards is precluded because effective application of standard would require scientific measure of risk).

\textsuperscript{207} See Campbell & Josephson, supra note 13, at 108.

\textsuperscript{208} See Murphy, supra note 4, at 239-40 (other characteristics relevant to risk level include promised benefits, amount of contributions, liquidity demands, actuarial assumptions regarding investment return, employer turnover, age profiles, life expectan-
Therefore, if a legislature dictates a maximum level of risk, it imposes costs on funds which possess the capacity to bear a higher level of risk. PEPPRA and ERISA have both chosen not to impose a maximum level of risk. While this allows funds to determine their own most efficient level of risk, when combined with a lack of specific investment standards, it could also lead to a regulatory framework without sufficient incentives to deter unscrupulous trustees from speculation at the cost of plan participants.\textsuperscript{209} The potential for trustee abuse in selecting a risk level is great both because the benefits from increased returns due to increased risk generally accrue to the benefit of the employer rather than the participant,\textsuperscript{210} and because it is unlikely that the courts will be willing to second guess the trustee's choice of portfolio risk level except in cases of flagrant abuse.\textsuperscript{211}

It is not clear that the drafters of PEPPRA ever considered who should determine the proper risk level for a particular public pension fund — Congress or the public pension fund trustee.\textsuperscript{212} However, balancing the costs of instituting a statutory maximum risk level for public pension funds against the additional safeguard this guarantees participants, should lead to the conclusion that it is in the best interest of participants to permit trustees to choose a risk level appropriate for the particular portfolio in question.\textsuperscript{213} Under the current system, however, where most public pension fund trust-
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ee face dual loyalties, the absence of both overall risk limitations and of individual investment scrutiny leaves participants open to expropriation by public pension fund trustees.214 The best solution, therefore, is to eliminate the conflicts of interest.

B. Eliminating Conflicts of Interest

PEPPRA fails to deal adequately with the problems posed by conflicts of interest among public pension fund trustees.215 PEPPRA expressly permits representatives of the employer, in this case the state or local government, to serve as trustees of public pension plans.216 Because this replicates present state law, it is likely that current state regulatory systems will remain intact.217 Under these systems, many fund trustees are government representatives.218 Yet, recent studies of public plans reveal that the potential for conflicts of interest resulting from state employees serving as trustees is a primary problem facing public plans.219 In addition, because Congress explicitly authorized trustees to consider the societal impact of their investment decision,220 and because PEPPRA permits public funds to carry up to 5% of their assets in employer-sponsored securities,221 the proposed legislation expressly allows government representatives to act upon their conflicts of interest by making politically motivated investments which benefit either the state as a whole or their own personal political careers at the expense of plan participants.

Since the use of public officials as public fund trustees creates a potential for abuse, it should be disallowed unless it conveys special benefits which cannot be achieved through the appointment of independent trustees. In this respect, two arguments can be made in

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214. See Herbert, supra note 4, at 166.
215. Conflicts problems are not independent of prudence requirements. While PEPPRA allows clear conflicts, the prudence requirements it adopts were developed in situations where the trustee was presumably independent from both the settlor and the beneficiaries. See Herbert, supra note 4, at 159. Where the trustee and the income beneficiary are the same, the trustee's judgment necessarily reflects his own self interest. Id. at 166. See also Marshall v. Teamster Local 282 Pension Trust Fund, 458 F. Supp. 986, 990 n.9 (1978) (citing Fiduciary Standards, supra note 160, at 968 for the proposition that normal private trust tension between high income and safety does not exist for pensions).
218. See supra note 42 and accompanying text.
219. See Task Force Report, supra note 2, at 4-5; L. Kohlmeier, supra note 4, at 9.
favor of continuing to permit state representatives to act as public pension fund trustees. The first argument involves the claim that state representatives are responsive to the will of the people, either directly or indirectly, through the electoral process.\footnote{222} This, however, is precisely the problem. Because they are politically accountable, public officials may act as if their duty lay with the state or locality as a whole, rather than solely with fund participants. This violates a trustee’s duty to act exclusively to benefit participants.\footnote{223}

The political process does provide plan participants with a means of ousting ineffective or dishonest trustees. However, public employees often comprise only a small part of the relevant population and, therefore, would presumably not have the power to vote trustees out of office.\footnote{224} Moreover, because the rest of the population may benefit from questionable practices such as local investment engaged in by public pension trustees, they might not support public employees at the ballot box. In addition, by the time the detrimental effects of poor trust fund management are felt, that is, at retirement, the trustees who caused the problem may have left public office.\footnote{225}

Thus, the reputational effects of mismanagement by government officials may not influence the political processes by which they are chosen as fund trustees. One solution to this problem might be a reform of the political selection process so that trustees undergo periodic approval by pension participants themselves, rather than by the population as a whole.\footnote{226}

The second argument in favor of allowing state representatives to act as public pension fund trustees involves the claim that because

\footnote{222. A recent Peat, Marwick and Mitchell Report on the Minnesota State Board of Investment supports board membership of state constitutional officers as elected representatives of the taxpayers who ultimately support the plan. See Murphy, supra note 4, at 231 n.81. See also Fiscal Distress, supra note 13, at 1016 n.132 (noting argument that judicial protection is unnecessary because participants exercise considerable political power).


225. This problem stems from the fact that most political appointments are on an ex officio basis. See Task Force Report, supra note 2, at 67. One commentator has concluded that elected officials should not be permitted to act as trustees. See Murphy, supra note 4, at 255. The Ohio Attorney General has interpreted his state’s enabling legislation for transit authority pensions as prohibiting elected officials from serving as fund trustees. See Murphy, supra note 4, at 253 n.182. See also L. Kohlmeier, supra note 4, at 55.

226. But see Murphy, supra note 4, at 255-56 (rejecting direct election of pension plan trustees by either plan participants or entire electorate).}
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the state or locality is sponsoring the plan, the state should have a right to help determine how the plan is managed. While it cannot be contested that the state must retain some control over certain aspects of fund management, decisions regarding investment of fund assets arguably should remain free of state control. Some decisions, such as the method of funding benefits, directly affect the fiscal stability of state and local governments. State representatives should be permitted to participate in these aspects of fund management. However, once assets are transferred to a public fund, the state’s interest in the daily management of those assets is greatly reduced because the assets have essentially become the property of the employees. Of course, if fund assets are so poorly invested as substantially to increase the cost to the state or locality of funding the plan, then the state would have a legitimate complaint. The question is how to balance these conflicting concerns, that is, how best to protect both the interest of the state as sponsor and the interest of employees as beneficiaries.

One answer might be to amend PEPPRA by deleting the provision specifically permitting state representatives to act as pension fund trustees. Such an amendment would not necessarily mean that state representatives could never act as trustees; rather, it would mean that their actions as trustees would be analyzed under the general requirement of PEPPRA that they act “solely to benefit” fund participants and refrain from self-dealing transactions. Strict application of PEPPRA’s fiduciary requirements would force trustees more seriously to consider participant interests before acting and might have the additional benefit of discouraging state representatives from participating in fund investment decisions.

227. See L. Kohlmeier, supra note 4, at 55 (“State and municipal governments and their taxpayers have an equal stake.”).

228. See generally Task Force Report, supra note 2, at 144-79; R. Tilove, supra note 34, at 131-73.

229. See supra note 74 and accompanying text. But see L. Kohlmeier, supra note 4, at 55 (arguing that state representatives must be permitted to participate in investment decisions).

230. Elimination of the provision in PEPPRA which explicitly permits employee representatives to act as fund trustees would mean that these are no longer “authorized” conflicts. Transactions involving authorized conflicts are merely subject to a rule of good faith. See supra note 40 and accompanying text; Withers v. Teachers Retirement System, 447 F. Supp. 1248 (S.D.N.Y. 1978); Campbell & Josephson, supra note 13, at 73-80 (discussing authorized conflicts). However, strict application of the general fiduciary requirements of PEPPRA in conjunction with the prohibited transactions rule would effectively bar state representatives from participating in most investment decisions. See H.R. 5134, 98th Cong., 2d Sess. §§ 204, 206 (1984). See also Campbell & Josephson, supra note 13, at 79. If the exclusive benefit rule is to have any substance, it should be interpreted to require an independent trustee. See Herbert, supra note 4, at 160.
State representatives concerned with their ability to comply with PEPPRA's fiduciary standards, yet desirous of retaining control over public plans, could delegate investment decisions to an independent investment board with expertise in the management of fund assets, while retaining their own seats on the board of trustees.\textsuperscript{231} Under traditional trust law, a trustee is not permitted to delegate the responsibility for investment choice.\textsuperscript{232} This rule has been generally applied to public pension fund trustees.\textsuperscript{233} Thus, the trustee has been unable to rely on the advice of others in scrutinizing investment decisions.\textsuperscript{234} PEPPRA, on the other hand, specifically allows the public fund trustee to delegate his investment decision.\textsuperscript{235} PEPPRA holds the investment manager to the same fiduciary duty as it does trustees.\textsuperscript{236} Delegation of the investment decision, therefore, would shield participants from potential investment conflicts caused by either state representatives or union officials serving as trustees, yet would allow such trustees to retain influence over non-investment decisions affecting their interests. This would serve to protect participants and at the same time recognize the legitimate interest of the state as sponsor.

\textit{Conclusion}

Current regulation fails to protect public plan participants from trustee misconduct. Plan participants also have limited market mechanisms enabling self-monitoring of trustee investment decisions. States have not acted to correct the situation, and an analysis of state interests in continued trustee flexibility suggests that state

\begin{itemize}
\item \textsuperscript{231} Investment boards provide an effective means of insulating the investment decision from political pressures. See T. Bleakney, supra note 6, at 145. Under a corporate structure, administration of benefits should be separated from investment decisions. See Hearings, supra note 3, at 73 (statement of Suzanne Taylor, Connecticut Education Association). Most public pension funds are set up as public corporations. See Murphy, supra note 4, at 228. However, only 2.1% of public plans have a separate investment board. See Task Force Report, supra note 2, at 189. The board should confer broad power and autonomy on those authorized to invest its assets. See Murphy, supra note 4, at 243. See also id. at 221-22 (arguing for use of multiple outside investment managers to encourage intrafund competition). See generally L. Kohlmeier, supra note 4, at 18.
\item \textsuperscript{232} Restatement, supra note 24, at § 171.
\item \textsuperscript{233} See, e.g., Withers v. Teachers Retirement System, 441 F.Supp. 1248, 1254-1255; Task Force Report, supra note 2, at 189; Campbell & Josephson, supra note 13, at 103-04.
\item \textsuperscript{234} Id.
\item \textsuperscript{235} H.R. 5143, 98th Cong., 2d Sess. § 202(c) (1984).
\item \textsuperscript{236} H.R. 5143, 98th Cong., 2d Sess. § 3(13) (1984). Such a broad definition would likely impose fiduciary responsibilities on numerous persons who would not be considered trustees at common law. See Herbert, supra note 4, at 157 (discussing similar provision in ERISA).
\end{itemize}
action should not be expected. For these reasons, federal regulation of public plan trustee investment decisions is necessary.

Congress has proposed one attempt at such regulation in the form of PEPPRA. PEPPRA recognizes the financial concerns which must underly regulation, but its response is insufficient. PEPPRA eliminates restrictions on investment choice and does not fall into the trap of compensating with an externally imposed maximum risk level. However, PEPPRA fails adequately to counter trustees’ increased flexibility with more stringent fiduciary obligations and continues to authorize the use of trustees with clear conflicts of interest.

Though PEPPRA is a first step toward protecting public plan participants, it does not go far enough. Federal regulation, if it truly desires to protect public plan participants from trustee misconduct, must bar trustees with clear conflicts of interest. If state interests demand participation in public plan management, at the least, state representatives must be required to delegate investment decisions to independent investment counselors bound by strict fiduciary obligations to plan participants.

—Kathleen Paisley