Testimony of

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On

"Creating Greater Accounting Transparency for Pensioners"

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Chairman Andrews, minority leader Price, and members of the Committee. My name is Matthew Hutcheson. I am a professional independent fiduciary. Retirement plan sponsors may appoint me to serve as the responsible decision maker for their plans to fulfill those often complex and time consuming obligations. In my role as fiduciary, I have made decisions directly affecting the lives of hundreds of thousands of hopeful retirees expecting to receive many billions worth of future benefits.

We live in an increasingly volatile and uncertain business world. As a result, many plan fiduciaries are exploring alternative investments to improve portfolio performance and reduce risks.

It is likely that interest in alternative investments will continue to spread, not only for the potential merit of the alternative investments alone, but particularly due to concerns about the economy and Wall Street's integrity, even in the face of sweeping legislative reform. There is significant "financial industry fatigue," and alternative investments offer a sense of hope for some.

Generally speaking, an alternative investment means any investment vehicle except stocks, bonds, mutual funds, cash or property. Examples of alternative investments may include tangible assets (i.e. gold or art), commodities, private equity funds, hedge funds, and closely held stocks.

Other examples of alternative investments, although not usually referred to as such, are derivatives and "guru portfolios."

Derivatives are those speculative instruments that brought Lehman Brothers and Bear Sterns down, and nearly destroyed our financial system.

Guru portfolios are so-called investment strategies based on special knowledge and expertise the guru is purported to have. That is how the guru claims it is able to outperform its competitors.

"Guru's" play to the investor's ego; making the investor feel special and smart for knowing the guru, and being "permitted" to invest with him or her. Many times, the guru is falsifying accounting records to make the investment performance appear better than it is. Investor's attention becomes focused on short term gains instead of long term values. Bernie Madoff is the most famous example.

The due diligence burden retirement plan fiduciaries have when investigating alternative investments is significantly higher than it is for publicly traded securities, for obvious reasons. It requires greater knowledge and insight into relevant issues. Most fiduciaries of employer sponsored retirement plans are ill prepared to perform an appropriate level of due diligence. While the plan itself is considered to be an "accredited investor,"[1] individual fiduciaries might not otherwise be. The participants in the plan are vulnerable to the decisions made by the fiduciary.

There are several reasons that performing due diligence and proper monitoring of alternative investments is so difficult. First, the fair value of the investment may be difficult to determine. Even when a fair value is assigned to an investment, its validity may be subject to debate. For example, the reported fair value of an investment could reasonably change by "changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances."[2]

"Unobservable inputs,"[3] are assumptions the investment manager makes based upon what he or she believes potential investors will pay for an interest in the investment. Those assumptions are to be based upon the best information available at the time, and given the specific circumstances affecting the investment. However, there may be multiple unobservable inputs that are equally valid, but that materially change the calculated fair market value.

Unobservable inputs are not transparent to potential investors. That's why they are called "unobservable." They can lead investors to incorrect conclusions and even significant investment losses, even when all parties are otherwise acting in good faith.

There is another reason performing due diligence on alternative investments is tricky for fiduciaries. Often, only limited historical information is available on the investment. The historical behavior of an investment is the basis for return on capital expectations, and also expected levels of risk and volatility. It also makes monitoring against a benchmark virtually impossible.

"Expected return"[4] is the foundation of capital markets. If investors are unable to *expect* something favorable in return for the investment of their capital, the market system would cease to function properly. The flow of investment dollars would dry up, and the capital markets would freeze.

Assets in a retirement plan are held in trust for the future retirement income of plan participants and beneficiaries. Creating and securing retirement income is

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[1] http://www.sec.gov/answers/accred.htm

[2] FASB Issues Proposed Update on Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. CAQ Alert #2010-41 – July 14, 2010

[3] CPA Journal. http://www.nysscpa.org/cpajournal/2006/1106/infocus/p14.htm

[4] http://www.investorwords.com/1840/expected_return.html

the overarching objective of ERISA. In order to properly govern a retirement plan, the portfolio must be structured in such a way to produce an *expected return* over a defined investment time horizon. If a fiduciary does not know what to expect in return for the investment of trust assets, it is in the realm of speculation. A fiduciary would also be unable to fairly compare two or more alternative investments.

Fiduciaries are obligated under current regulation[5] to avoid imprudent speculation by applying proper principles of economics and finance to portfolio construction and management. Thus, a lack of historical information can pose a significant challenge, if not a road block altogether, for fiduciaries considering a particular alternative investment.

Finally, the cost of buying and selling alternative investments can be very high. Those costs can be difficult to quantify, and are not frequently disclosed in an easy to understand format.

There are four practical ways to protect retirement plan participant's future retirement income from the inherent accounting, valuation, and due diligence challenges presented by alternative investments.

1. Require audit of internal controls: Require that alternative funds have an independent auditor sign off on internal controls based upon the Committee of Sponsoring Organizations' ("COSO") definition of what it means to effectively evaluate internal controls.[6] Auditing internal controls today isn't as time-consuming or as costly as it was when large public companies first began complying with one of the most onerous requirements of the 2002 Sarbanes-Oxley Act, known as Section 404. Although the Sarbanes-Oxley Act is directed at public companies, many privately owned companies and nonprofit organizations are electing to evaluate their systems of internal control using COSO's framework.[7] Alternative investment managers can too.

2. Require understandable financial statements: President Obama is quoted as saying, "I think we have to restore a sense of trust, transparency and openness in our financial system."[8] It is urgent that we do so. It starts with creating financial statements that retirement plan fiduciaries can actually

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[5] Application of modern investment principles in qualified retirement plans. [Labor Reg. § 2550.404a-1 (42 FR 54122, 1977)], [ERISA Reg. § 2550.404a-1], ERISA Interpretive Bulletin 94-1, etc.

[6] http://mcgladreypullen.com/Resource_Center/Audit/Articles/WhatIsCOSO.html

[7] "Turbo Charge Your SOX Program With the New COSO Monitoring Guidance." July 8, 2010 by Stephen Austin, CPA, MBA. www.cpa2biz.com.

[8] http://wallstreetpit.com/2430-improving-transparency-regaining-investors-trust

understand. Retirement plan fiduciaries want a "plain English" executive summary to an investment's annual report and more complete disclosures.[9] Indentifying a reasonable expected return on capital will otherwise be difficult at a minimum and perhaps even impossible based on what those familiar with such matters would otherwise require before proceeding with an investment.

3. Enterprise risk management skills: Strong enterprise risk management skills should be the hallmark of every alternative investment management team. Fiduciaries considering alternative investments must possess sufficient knowledge themselves to investigate whether alternative investments are being managed by individuals with such skills. There must be a common, standardized language between all alternative investment managers, auditors, and plan fiduciaries. Key principles, concepts, and guidance must be conveyed under a common framework.[10] A fiduciary's ability to accurately compare two or more competing alternative investments depends on it. That will restore investor confidence and give retirement plan participants and retirees the protections they deserve.

4. Fair Valuation Standards: The Financial Accounting Standards Board recently published proposed amendments to its fair value measurement and disclosure rules. An explanation can be found on the Board's website.[11] The proposed amendments enhance and standardize the method of valuing alternative investments by the U.S. based Generally Accepted Accounting Principles (GAPP) and the International Financial Reporting Standards (IFRSs). It focuses on standardizing how elements of uncertainty that may affect a fair market value are disclosed. For example, disclosure of the use of one unobservable input over another in a fair market valuation, and how it might have affected the resulting value. This is particularly important for plan fiduciaries investigating the merits of international alternative investments. Legislation could augment those rules with respect to employer sponsored retirement plans. That would enhance confidence that the integrity of valuation method being applied to several considered alternative investments is sound.

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[9] "A number of dialogue tour participants proposed adding a "plain English" executive summary to annual reports. Others suggested that "click-down" online technology could let users control how deeply they delve into a particular company's public reports. We also found considerable support for more complete and understandable disclosures on executive compensation. In short, investors have made it clear that they want more transparency." http://www.icahnreport.com/report/2009/01/improving-transparency-regaining-investors-trust.html

[10] http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf

[11] http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176156961430

In conclusion, perhaps the most important participant-protecting skill is application of the fiduciary standard. For example, in my capacity of a professional fiduciary, I have never permitted trust assets to be invested with Madoff, Bear Sterns, or any other alternative investment that failed to meet a fiduciary smell test. While many sophisticated institutional and high net-worth investors lost billions with Madoff, not one participant under my fiduciary jurisdiction has ever been exposed to Madoff, Bear Stearns, failed hedge funds, or other investments such as those. The fiduciary standard of care, coupled with clear evidence of risk management skills, internal controls, and demanded transparency protected my participants. This committee can develop policy intended to help all other fiduciaries apply the same due diligence expertise of alternative investments.

Thank you.