Testimony of Michael Musuraca
Assistant Director, Department of Research and Negotiations
DC 37, AFSCME, AFL-CIO
And Designated Trustee of the New York City Employees Retirement System
To the United States Senate Subcommittee on Consumer Affairs, Foreign Commerce, and Tourism
Of the Committee on Commerce, Science and Transportation
On Examining Enron: The Consumer Impact of Enron's Influence on State Pension Funds
May 16, 2002

Good afternoon. My name is Michael Musuraca. I am an Assistant Director in the Department of Research and Negotiations, District Council 37, AFSCME, AFL-CIO, and a designated trustee to the New York City Employees Retirement System (NYCERS). On behalf of the 125,000 members of District Council 37 and the 1.3 million AFSCME members throughout the nation, I am grateful to the Senate Commerce Committee for the opportunity to discuss the impact of the collapse of Enron on large institutional investors and public pension funds. The nation's 37 largest public pension funds suffered combined losses exceeding $2 billion at the hands of Enron. AFSCME believes that in order to reduce the likelihood of this happening again, workers and retirees should be equally represented on pension fund boards and blatant conflicts of interest by corporate executives, auditors and investment advisors must be eliminated.

NYCERS is the largest of New York City's five pension funds, with over 300,000 active and retired members, the majority of which receive an annual benefit of less than $25,000. The total assets of NYCERS, the Teachers, Police, Fire, and Board of Education employees pension funds is approximately $85 billion, of which NYCERS accounts for slightly over $35 billion. While member benefits were not threatened, the combined losses of the five funds due to Enron's collapse was $109 million, $83 million of that total was from losses in the value of Enron stock, while $26 million came from assorted bond holdings.

The stock losses suffered by the NYCERS and the other City pension funds came from their holdings in a domestic equity index run on behalf of each system. Like many other large institutional investors, NYCERS and the other City pension funds have increased their exposure to the U.S. stock market through index funds over the past decade. NYCERS, for example, currently allocates over $17 billion, or 87.5% of all domestic equity investments, to two index funds, the Russell 3000 and the S & P 500.

There are a number of reasons that large institutional investors use index funds for their U.S. equity portfolios. Index funds provide a relatively cheap method for pension funds to have a broad exposure to the full domestic equity market. Another, and perhaps the primary reason, that institutional investors have increased their exposure to the U. S. equity markets, especially for large cap companies like Enron, is that the information about the companies being traded is widely available to investors large and small. The widespread availability of information about companies to the investment community makes it more difficult for active managers to add value to a client's portfolio based on information that may not be in the public domain. Hence, not only are index funds seen as a cheaper method for achieving broad exposure to the equity markets, but one that allows institutional investors to fully capture value as well.

The obvious pitfall for institutional investors who are heavily invested in index funds is that the manipulation of a company's financial condition can lead to the price of a company's stock being artificially valued in the marketplace. In other words, if a company's filings with the Security and Exchange Commission (SEC) are fraudulent, or if market participants have reasons other than the company's performance and prospects to continue buying a stock, and thus artificially inflating the value of a stock within the index, the indexed investor is the natural victim of those practices.

This certainly happened in the case of the Enron Corporation, where NYCERS and other indexed investors held Enron as part of their S&P 500 or other indexed portfolio, stock we bought at prices based on what we now know to be Enron's false and misleading disclosures. Then, beginning in October 2001, the company made a number of negative disclosures about the company's financial condition and certain related-party dealings between Enron and entities owned and controlled by its Chief Financial Officer, Andrew S. Fastow. The disclosures led to a loss of over $600 million in the third quarter of 2001, the write-down of millions in assets, and a $1.2 billion decline in shareholder value. Shortly thereafter, the disclosure of accounting irregularities led the company to restate its earnings from fiscal years 1997 through the third quarter of 2001, so that reported net income for the period was lowered by nearly $600 million, nearly 20 percent.

These disclosures led to a swift decline in the Enron's stock and total market capitalization. The disclosures also accounted for the losses suffered by NYCERS and some of the 150 other public pension funds from New York to California in which AFSCME members participate throughout the country, and the nation's perception that something was seriously amiss in the nation's capital markets.

Unlike the New York City funds, other public pension funds suffered losses in accounts under active management. The Florida State Board of Administration (SBA), with whom the New York City funds joined in a failed attempt to achieve lead plaintiff status in the class action suit brought against the Enron directors, reported losses of more than $330 million, three times greater than the next largest loss, as a result of Enron's demise. The vast majority of the SBA's losses came from a domestic equity account managed by Alliance Capital Management.

Alliance Capital also managed such accounts for the New York City Firefighters Pension Fund and the New York State Common Retirement System. The fortunes of those pension funds, however, were dramatically different from that of Florida. While Florida reported losses of over $330 million, neither the City Firefighters nor New York State Common funds suffered losses of such magnitude. Indeed, the Florida SBA fired Alliance Capital shortly after Enron's bankruptcy, and earlier this month brought legal action against Alliance.

While it is a bit easier to fathom NYCERS' losses, we have not been able to determine the decision making process of either the Florida SBA or Alliance Capital that allowed Alfred Harrison, the Alliance investment manager in control of the Florida portfolio, to continue purchasing Enron shares even after the company was under SEC investigation; the SBA's investment policy on stock purchases had been breached; and the SBA analyst assigned to Alliance warned the board that the company stock price was in a free fall.

The AFSCME members that are members of the state pension system are most concerned that the SBA's own investment policies were broken when Alliance's purchases of Enron topped seven percent of the Florida portfolio, exceeding the six percent limit the SBA had set for Alliance's investment in any stock.

As a pension fund trustee in New York City, the chronology of the Alliance Enron purchases raises additional red flags, and the inaction of the SBA trustees is difficult to understand in light of the fiduciary duty that all trustees have to plan members and beneficiaries. While I do not know the specifics of the Florida investment statutes, the common law duties of prudence and care would have led for trustees to fully examine the actions taken by the manager of the Alliance portfolio.

On October 22, 2001, for example, the day that the Securities and Exchange Commission announced it would investigate Enron, Alliance bought 311,000 shares for the State of Florida.

In an October 24, 2001 memo, SBA staff member Trent Webster, who was responsible for reviewing the Alliance portfolio, alerted his boss, Deputy Executive Director Susan Schueren, to Harrison's Enron buying activity. The memo, in part, reads: "Enron's stock is being crushed. The primary cause is the concern about the company's accounting….A stock that is falling when a company has accounting problems is almost always a bad time to buy."

Despite the internal staff warning, Harrison continued to buy Enron stock on behalf of Florida, paying \$23 million for 2.1 million shares from October 25th, when Enron traded at \$15 per share, through November 16th, when its shares had dipped to \$9 per share.

Earlier this month, AFSCME's Florida Council 79 filed a Freedom of Information request with the SBA for all documents and communications with Alliance concerning purchases involving Alfred Harrison and other Alliance personnel to get to the bottom of what took place.

The Florida Retirement System is part of the Division of Retirement, which is headed by a director appointed by the Governor and confirmed by the State Senate. The Division is responsible for administering the trust and distributing benefits. The State Board of Administration, a state agency with its own staff, handles all investment issues. The SBA is composed of the Governor as Chair, the State Treasurer and State Comptroller. A six person Investment Advisory Council makes recommendations on investment policy, strategy, and procedures. All of its members are financial professionals and do <u>not</u> necessarily represent the interests of rank and file plan participants.

AFSCME believes that the structure of the SBA may, in fact, be a source of the trouble. Many public retirement systems have an independent board of fiduciaries, which include worker representatives or plan participants and retirees. Such representation helps to create a non-partisan environment where loyalty to the plan is the most important consideration, ensures a board's independence, and more easily allows for the necessary oversight of the investment process. Worker and retiree representation also brings to the boardroom a better understanding of what members need from their retirement system. Even retirement systems in which one elected leader is the sole fiduciary as in New York State and Connecticut, there are mechanisms in place that ensure a high level of plan member input and oversight. Such is not the case in Florida. AFSCME asks that the Committee consider three suggestions to help ensure that public funds trustees act as true trustee fiduciaries and manage retirement assets solely in the interests of plan members and beneficiaries. These changes could help prevent future catastrophic losses in their investment portfolios and strengthen their role as fiduciaries for worker retirement assets.

- Require all public funds to have half of the systems trustees appointed or elected from the ranks of the plan members and beneficiaries.

- Institute some type of pay to play requirements that prevent political contributions to trustees from investment managers that do business with the public fund on which they serve.

- Provide incentives for states to close the revolving door between asset managers and political leaders.

The Enron debacle has sparked a crisis of confidence in the nation's capital markets that Business Week recently suggested has raised the public's furor at the business community to levels last seen during the trust-buster era of Theodore Roosevelt. More recent revelations, uncovered by New York State Attorney General Eliot Spitzer's investigation of Merrill Lynch, about the complicity between investment management firms research analysts and their investment banking business, has only served to stoke the flames.

Clearly Americans, who as members of defined benefit pension plans like NYCERS or who participate in their company's deferred contribution plans, have come to believe that the deck is stacked against them as they seek to invest a portion of their earnings for their children's college educations and their own retirement. The daily revelations about new Security and Exchange Commission investigations, indictments, and company restatements of earnings only serves to convince more average Americans that the system is rigged to their disadvantage.

In order for Americans to regain a sense of confidence in the nation's capital markets and the security of their retirement funds equal representation of workers and retirees on public pension funds is vital. So is worker representation on private company 401-k plans, as is provided in Senator Kennedy's pension reform bill. AFSCME also strongly supports reform of our nation's capital markets – the markets our members' retirement savings are invested in. Senators Nelson and Carnahan have proposed strong legislation in these areas, as has Senator Sarbanes and Senator Leahy.

In the face of inaction from the SEC and inadequate reforms passed by the House, the Senate needs to move quickly on these measures to protect working families' retirement savings from conflicts in the capital markets.

AFSCME's members are the beneficiaries of trillions of dollars invested in our nation's capital markets. This money is their future. Public Servants and all working families deserve better from our markets, our money managers, and the regulators than we got at Enron. Thank you.