

**REMARKS BY ARTHUR LEVITT, JR.**  
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Thank you for that kind introduction, and for welcoming me back to my hometown, New York.

For many years, there was only one Arthur Levitt known in this state - -and that was Arthur Levitt, Sr. No matter what I may achieve in my life...no matter what accolades I may earn...it will never approach the level of esteem held by many New Yorkers for my late father – who served for 24 years as New York State Comptroller.

In that role, my father was the sole trustee for New York’s state-run pension system. My mother was a public school teacher, so, technically, my father worked for my mother – a fact that she never let him forget.

From both of them I had ingrained in me a deep sense of public service and a commitment to the stewardship of the public interest above all else.

And it’s a lesson that they taught me for many years – in fact, deep into my adulthood.

I’ll never forget in 1978, as New York City was facing yet another fiscal crisis, my father was accosted in the halls of the state capitol by Mayor Koch. The Mayor wanted to tap the pension funds to bail New York out. My father refused saying that he: “would make no such commitment because it would violate [his] fiduciary responsibilities as trustee.”

Koch told him that: “If New York City fails, it will be your fault.”

True to his plain-spokenness, my father called the charge, "irresponsible nonsense." He didn’t budge from his position. The city found another way out of its crisis. And the retirements of millions of workers were saved.

So, I come here today not just with a long history of interest in the public pension system, but with a deep admiration for the responsibility placed on a fund trustee’s shoulders.

Unfortunately, across the country, there are too many fund trustees as well as elected officials who – apparently – are unable to carry this load.

The GAO report issued last Friday found that 60 percent of the 126 largest public pension funds are fairly well funded – yet these cities and states still face large health care liabilities that at current growth rates will jump 150 percent by 2050.

And some of the state and local governments that have improved the funding status of their plans have done so by issuing debt to the investing public in the form of pension obligation bonds. Needless to say, that debt is still outstanding and will require governments to fund payment in the future to those investors.

Beyond these, there are still many funds that have significant unfunded pension liabilities and future health care obligations. In Texas, for instance, a recent survey found that four-fifths of nearly 100 public retirement plans are underfunded by a total of \$22 billion.

Here in New York, there are other problems. The immediate past state comptroller not only has been drummed out of office for misusing state resources, but allegations swarm about millions of dollars made by his son and close political advisor in steering business to the state pension fund.

These are just some of the examples of bad behavior, poor decision-making, and political positioning that have created a ticking time-bomb in our public pension system.

I saw up close what happens when this bomb goes off during my recent service as head of the audit committee charged with investigating and remediating allegations of problems surrounding San Diego's pension funds and finances.

Here was one of the nation's most beautiful, wealthiest cities with a strong regional economy, and it was on the brink of bankruptcy thanks to a group of political leaders more interested in looking out for themselves in the short term than the fiscal health of their city in the long term.

And let me add that while the SEC took action against the faceless entity of the city, I am disappointed that they failed to bring a single action -- or hold accountable -- those individuals responsible for the San Diego pension crisis. Individuals were behind this debacle -- and individuals must be held responsible.

In too many places around the country, elected officials who have made promises to provide for their workers in retirement, fail to deliver.

If politicians aren't willing to pay for their promises, then they shouldn't make these hollow promises in the first place.

Of course, most pension trustees are like yourselves -- committed to the secure retirements of your system's members and dedicated to doing the right thing.

But as the amount of money in the public pension systems swells to \$3 trillion...as public pension funds become ever bigger market actors investing in a range of asset classes -- including private equity...and as the Baby Boomers begins to retire, we cannot tolerate a shaky pension system. Now more than ever, we need to put public pensions on sound financial footing.

Today, I want to talk about the structural changes public pensions can take to untangle conflicts of interest, improve governance, increase transparency, and -- most of all -- help ensure that those who rely on these pensions will have them not only when they retire, but for years to come.

My remarks are deeply informed by my past -- as the son of Arthur Levitt and from more than 40 years working in and around the markets. But they are also informed by my present -- as someone who works for a private equity firm.

More and more, public pension funds are investing in alternative investment vehicles -- reflecting the maturity of both. And as you continue to invest in these funds, issues of governance and ethical behavior will be front-and-center.

Make no mistake: any discussion of how to fix the mistakes of the past must include careful consideration of the realities of the present.

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We can't begin to improve the fiscal standing of public pension funds until we can accurately assess their financial health. And we cannot do that until we have accounting standards that give all stakeholders an accurate diagnosis.

Currently, weak disclosure rules fail to reflect accurately the assets and liabilities of public pension plans.

Alternative and varied actuarial procedures can be abused to lower reported costs and liabilities.

Consider what has happened across the river in New Jersey.

The state reported in a bond offering statement that it contributed \$551 million to a pension fund for its teachers in fiscal year 2005. In an audited financial statement, the contribution was said to be \$56 million. Yet, the actual figure was neither – it was zero.

Makes you wonder if New Jersey used the same accountant as Tony Soprano...

The Governmental Accounting Standards Board – or GASB – recently has taken some important steps toward improving reporting and transparency – especially with regards to liabilities for healthcare costs and other post-employment benefits.

But GASB rules still lag far behind similar rules laid down for public companies.

It's time to improve accounting standards for public pension and healthcare obligations to make sure that all liabilities are reported in the balance sheets of state and municipal governments, not just in their footnotes.

We need to stop the manipulation of actuarial projections and make them consistent and comparable from city to city. Earnings manipulation in the private sector and actuarial smoothing in the public are two sides of the same coin. And public pension funds that have been strenuous opponents of the former must be equally vocal in opposing the latter.

Quite simply, pension plans need to practice what they preach.

We need to continue to move to a system in which assumptions are realistic...in which a clear picture of a plan's financial health can be seen...and in which it's difficult for politicians to pressure accountants to squeeze numbers for their partisan gain.

We need stronger oversight and standard-setting. That will take a GASB with an independent funding source...and with its members chosen not based on their membership in a particular constituency group, but on who is best qualified.

To make this happen, the SEC should be the one who selects the trustees who choose GASB members.

And throughout the larger market for municipal securities, we need to greatly improve transparency, governance, accountability, and investor protections. I agree with Chairman Cox that the securities laws should be revised to accomplish this – and that means, specifically, revoking the Tower Amendment.

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Once stronger rules and the independent regulatory body to enforce them are in place, we will begin to get a clearer picture of funds' fiscal situation.

But better accounting standards and a stronger standard-setter are only part of the solution.

Public pension boards themselves need to improve their governance to meet the great challenges pension systems now face – and to adequately assess the wide-range of investments they may make.

I am concerned that trustees lack the necessary information and education to oversee their employees and advisors.

With growing latitude in asset allocation and the complexity of investment vehicles chosen, many trustees are inexperienced with the types of investments being made – whether they are structured financial products or complex trading formulas used by a certain hedge fund.

Or they lack the knowledge to be able to judge the risks the fund may be taking with a specific investment – or how to judge the conflicts of interest the experts they rely on may have.

A recent survey of state pension systems found that of the 25 that reported back results, only nine of them – a little more than one-third – had any formal education policy for members.

It is unrealistic to expect that trustees drawn from the ranks of employees would be experts in pension finance and investing.

But it is unfair to workers to put their retirements in the hands of a board that does not have the wherewithal to be true trustees.

To boost the quality and competence of the board, there should be, at the very least, mandatory minimum annual educational requirements for all pension trustees.

Serious thought also should be given to mandating that a number of trustees be qualified as financially literate much in the same way Sarbanes-Oxley mandates those requirements for the audit committees of public companies.

Along those same lines, public pension plan boards should have the authority and resources to hire their own legal counsel, auditor, and actuary.

Access to these independent points of view is essential to good governance.

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I also am deeply concerned with the conflicts of interest seemingly built into public pension plans.

Too often, politicians serving as trustees – or acting as the plan sponsor – use workers’ retirements to make a political statement. Recently, this is taking the form of divestment from companies that do business with Iran or the Sudan.

Neither of these regimes merits a defense for their odious behavior and offensive policy statements. But it is wrong to play politics with the retirements of state workers. This is their money – deducted from their paychecks and from matching contributions that they have earned.

That’s why the only investment consideration a trustee should make is whether or not a decision is good for the financial well-being of the pension plan. If using that criterion, divestment is warranted – then such a step should be taken.

If not, then politicians should find other avenues through which to make political statements.

There are other instances where the overall health of the plan is not placed first and foremost.

On many boards, trustees are beneficiaries of the plans themselves – representing large groups of workers and retirees.

While having the best of intentions, too many trustees either put short-term considerations for their -- or their colleagues’ -- retirements above the long-term interest of the entire plan.

They are too slow to address the legitimate concerns of taxpayers, and – I fear -- that they will inadvertently or – even at times intentionally – game the system.

In response, it’s important that boards include a balance of representation – not just with financially-qualified individuals, but also with enough disinterested, public-minded citizens sitting on them to ensure that the big picture is always in focus.

Of course, this is easier said than done.

Democracy requires that all voices be heard – and when it comes to their retirements, people absolutely must have their say.

However, having that sort of representation combined with the vast amounts of money at stake also creates the potential for abuse. This is inevitable. Trustees are human.

But the potential for this mischief-making is significantly increased if we put good people into a bad system.

Right now, we have done just that.

With the escalating costs of political campaigns...the enormous sums of money to be invested...and the prospect of huge payoffs for private equity firms, hedge funds, and their agents if they are able to attract even a sliver of this capital...we have created a situation in which workers’ retirement savings are being used for private gain.

What I'm talking about is pay-to-play – the selection of investment advisers to manage public funds based on their -- or their representatives' -- political contributions.

I first wrestled with this issue 8 years ago during my tenure as SEC Chairman. After seeing the success we had in stopping pay-to-play in the municipal bond market, I believed that the time had come to do the same with public pension investing.

I directed the staff of the SEC to investigate the situation, and they uncovered a whole raft of suspicious and criminal activity.

Since then, the amount of money in play has increased exponentially as has the pressure to produce out-sized returns.

With thousands of hedge fund and private equity firms now in operation, the competition for investment dollars is fierce – as intense as the competition for campaign dollars.

Unsurprisingly, we have not seen a let-up in pay-to-play problems.

It is not rare for a pension fund board member to call an investment adviser for the fund and ask them to make campaign contributions to a political official who will keep that pension board member on the board -- or if the trustee is an elected official himself, ask for a contribution outright.

And Chicago, Philadelphia, Illinois, Ohio, and California -- not to mention New York State -- are just some of the places that have had to deal with pay-to-play scandals over the past half-decade.

When I first spoke out about this in 1999, the state treasurers and Government Finance Officers Association claimed that they'd take care of the problem – and strenuously opposed my proposal for reform.

In light of these recent events, the time to end pay-to-play in public pension funds is long overdue. To that end, the SEC should revisit the 1999 proposal never acted upon to bar investment advisers from making political contributions to certain elected officials.

At the same time, the private sector should move aggressively on its own to end pay-to-play.

First, public pension funds should follow the lead of funds like CalSTERS and the New Jersey State Investment Council and voluntarily decide to halt any business dealings with financial investment firms that contribute large sums to statewide elected officials who serve on their boards.

They should fully disclose in what firms they are investing, what pension advisers they may be using, and any relationships that any trustee may have with them.

Second, pension consultants also need to be scrupulous in defending their independence. They must not only disclose to their clients any relationships they or their top executives may have with any investment firms. They also must do so in a way that is relevant and understandable.

To that end, pension consultants should disclose any relevant potential conflicts to their pension plan clients each time they give advice on an investment – and be prepared to discuss the impact those relationships may have on their actual and perceived independence.

Third, private equity firms and hedge funds should undertake an effort along similar lines as the Municipal Securities Rulemaking Board’s Rule G-37 and require the disclosure of any contributions by the firm or its executives to elected officials or party entities with any connection to public pension business. If a contribution is disclosed, that should trigger a two-year time-out from doing business with that client.

Moreover, I urge alternative investment firms to voluntarily reject the use of paying finder’s fees to non-employees who deliver them pension fund business.

This practice has already caused them perceptual and actual problems, and when you’re dealing with close calls in such an important area as the management of a pension fund, coming down on the side of appearance as well as substance is important.

Let me be clear: I speak as someone who works for a private equity firm; my interest and experience lie with that. But these recommendations are equally valid – if not more so – for hedge funds and other investment vehicles, which are sometimes even less transparent. I hope that they would join with private equity in this effort.

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Now, I know that ending pay-to-play would be a significant change in policy and business practice.

But alternative investment firms can no longer beg off any change in behavior by arguing that they are “private” and only for the very wealthy.

Over the next several years, millions of Americans will find themselves with direct or indirect exposure to these kinds of investments. In the United States alone, the 20 largest pension funds have more than \$110 billion invested in private equity on behalf of ten-and-a-half million beneficiaries. And this pales in comparison to the \$600 billion that pension funds are expected to pour into hedge funds by 2010.

In addition, many of the public’s best-known and most beloved companies – from Dunkin’ Donuts to Chrysler – are now owned by private equity firms.

With these new pools of wealth come perceptions of great power. And with this sort of public profile comes public scrutiny – and even calls for restrictive or punitive regulatory action.

In response, alternative investment firms need to do a much better job in recognizing their public obligations...working with various stakeholders to ensure that they are comfortable with their investment plans...publicizing what their work brings to local companies and economies...and embracing best practices as an industry.

I believe that leading the effort to end pay-to-play presents private equity firms in particular with an opportunity to demonstrate to investors large and small that they understand and appreciate the constructive role they can – and often already do – play in the economy.

That does not absolve pension fund trustees of their role in this as well.

They too must lead in ending pay-to-play...and they must take proactive measures to burnish their reputations and build trust in the eyes of plan beneficiaries and the public.

Specifically, when pursuing private equity investments, that means pension fund managers should make sure:

- that private equity funds have the industry expertise and competence to manage the businesses they acquire...if a portfolio company runs into difficulties, the sponsors must have the skills to step in and address the problems.
- that they are able to make transparent to their investors valuations that are sometimes opaque to the outside observer...
- that funds not only have a consistent track record of generating high returns, but also focus on building long-term value for portfolio companies...
- that funds both have a record of successfully negotiating significant market downturns and a history of protecting investors when investment difficulties emerge...
- that they have a record of playing a constructive and sensitive role in the communities that their investments affect...
- and that funds have an ethical business culture, embracing – and setting – the industry's best practices ... from providing useful disclosure to ending pay-to-play.

These are guidelines that are good when assessing not just private equity firms, but also hedge funds and other alternative investments.

Whatever the investment, by following these principles, you will find investment opportunities that are both of the high quality that your beneficiaries expect and that help to build demand for responsible behavior on the part of investment firms.

It's a win-win situation for everyone involved.

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A lot has changed since my father oversaw the pensions of New York's state employees – from the rise of alternative asset classes to the widespread crisis of unfunded pension liabilities.

But one thing has not – and that's the obligation that trustees have to the workers who rely on them for retirement security.

Right now, pension trustees are at a crossroads: they can decide right now to demand honest accounting and find a way to put pension plans on solid financial footing – or they can continue to rely on a mixture of actuarial slight-of-hand and old-fashioned hope that plans will stay solvent.

They can make sure that trustee boards reflect the full breadth of stakeholders and that their members have the training and resources to ask the tough questions – or settle for a Darwinian type of management in which it's every man for himself.

And trustees can choose to help end pay-for-play once and for all – or prolong the life of a bad system that produces sub-standard results for retirees.

Ultimately, the choice before all of us -- public pension trustees, the investment community, legislators, and regulators -- is not just a matter of creating rules or imposing penalties.

It's about creating a public pension system that considers the retirement funding of municipal employees a trust rather than an obligation...an unbreakable covenant rather than a legal mandate...a pledge to the future civil guardians of our society rather than a vehicle for extracting entitlements.

If we do that, we'll create a community that will protect -- as a matter of honor and duty -- the future livelihoods of millions of our nation's workers.

Thank you.