GOVERNANCE

by Rachel McMurdie

Investing in Good Governance

Subprime-Related Losses Stir Up the Conversation

When the Florida State Board of Administration invested about $2 billion in structured investment vehicles (SIVs) and other debt instruments on behalf of its local government investment pool, the board, which also oversees the $138 billion Florida Retirement System Pension Plan, thought it was investing in a relatively safe account, one that happened to pay a little more interest than a bank would. But when the mortgage crisis and downgrades of asset-backed debt held in the portfolio began to drain funds from the bottom line, it became apparent that the investments were far from risk-free. The lower credit ratings and the looming prospects of loan defaults produced a run on the Florida fund that totaled $13 billion of redemptions in November and reduced the size of the investment pool by more than half. And Florida is not alone, as many other state-run funds also have incurred losses from subprime-tainted SIVs.

Assignments of blame, in the form of lawsuits, have followed the downturn. Pension funds might see themselves on the receiving end of lawsuits as much as on the giving end. Under ERISA rules, as interpreted by the American Institute of Certified Public Accountants, fund trustees and executives, not their consultants or managers, are responsible for the contents of their portfolios.

Furthermore, a recent Supreme Court case, LaRue v. DeWolff, if won by the defendant, would allow individuals to sue pension funds and open pension funds to even more liability.

"Every single day investors read about another case or class-action lawsuit of a firm going after a company over investment or stock issues, and it's really becoming very clear to them that there's equal exposure on the pension fund side through ERISA," says Stephen Rosenberg, an ERISA attorney with Boston-based The McCormack Firm. "They're realizing it's the same exposure they've been facing on the front end through good, old-fashioned securities lawsuits."

Executive Summary

- **The subprime mortgage crisis has renewed the topics of pension fund prudence and good governance.**
- **Pension funds could face increasing litigation from beneficiaries.**
- **The adoption of best practices could help pension funds steer clear of legal troubles.**

Already a number of litigations are unfolding, says Susan Mangiero, president of Pension Governance, an independent research and analysis company that tracks pension litigation and investment best practices. The recently launched website, www.pensionlitigationdata.com, a partnership with The Michel-Shaked Group, includes more than 1,500 lawsuits, many of which reflect complaints against third parties such as consultants, asset managers and actuaries. "The number of new filings is clearly on the rise. We are adding 300 to 400 new cases each quarter," says Mangiero. "More than 90 percent of these cases allege fiduciary breach, meaning that decision makers are accused of not doing their job properly."

While some who are defending companies and plans against litigation will likely brush off these as "me too" suits, the reality is that a lot of them are going to be settled for a lot of money, says Rosenberg.

"I don't think they're all going to disappear," he says. "There's a lot of smoke there, so I think they're seeing a lot more exposure on [the pension fund] side. And the reality is that the class-action bar is targeting that side now, so that puts it on pension funds' plates as a major issue they have to stay in front of."

AN ENRON-LIKE PENSION COLLAPSE

News of increased pension fund litigations comes at a time when institutional investors are increasingly under scrutiny for their investment decisions. New accounting standards are likewise keeping pension investors on their toes. Add to that the subprime mortgage debacle and you have yourself a perfect storm, conditions ripe for an Enron-like pension fund collapse, some experts warn.

"Everybody agrees that the tipping point is near," says Mangiero. "It won't be pretty for those who realize large losses. People must pay closer attention to the proper identification, measurement and management of investment risks. That includes making inquiries about how their fund managers deal with risk, how they value thinly traded securities and the extent to which they employ leverage."

With a new awareness of risk, the conversation on good governance has changed dramatically, says Rosenberg. "The subprime problem in particular has brought it home for people," he says.

WHAT CAN BE DONE?

Most investors would agree that more needs to be done to promote transparency, inhibit conflicts of interest and bring light to opaque accounting practices, but regulators and executives that oversee funds are divided over how to best proceed.

In a speech to pension officials in October, Arthur Levitt Jr., the longest-serving chairman of the Securities and Exchange Commission, called for a repeal of the Tower Amendment, which shelters government entities from some of the accounting standards that corporations are held to. He also suggested that, in order to avoid inherent conflicts of interest, Congress should create an independent source of financing to fund the body that writes the accounting rules for governments — something Congress already has done for corporate accounting rule makers. Though the current SEC chairman, Christopher Cox, has not called for its outright repeal, he also has expressed his doubts over the Tower Amendment's continuing usefulness.

Already faced with tougher accounting requirements under FAS 157, public pension funds may feel overwhelmed by additional regulations.

Rosenberg believes regulations won't get at the root of the problem. "The problem we're seeing consistently is that [pension funds] don't do sufficient investigation. They don't bring in sufficient expertise and they get blind-sided. First it was company stock, then it was excessive fees, now it's subprime," he explained. "If you rely on regulation, it seems like you're always fixing the last investment problem. I'm not sure you can regulate the problem out of existence."

But what regulators can do, Rosenberg says, is impose tougher regulations on sellers that would make their products more transparent. Investors, for their part, he says, should take preventative action against lawsuits and protect themselves by imposing better internal practices.

Cover All Your Bases

In response to a rising number of pension fund scandals, the committee of the Stanford Institutional Investors' Forum at Stanford Law School, in cooperation with the Arthur and Toni Rembe Rock Center for Corporate Governance, published last June a set of best practice principals for managing pension, endowment and charitable funds. The report calls for the adoption of basic policies aimed at improving how pension funds govern themselves, with the goal of making plan sponsors more accountable to their beneficiaries. The *Clapman Report* recommends that pension funds:

- Clearly define and make publicly available their governance rules;
- Mandate tough and transparent policies to address conflicts of interest;
- Take steps to ensure funds have trustees who are competent in financial and accounting matters;
- Establish clear reporting authority between trustees and staff; and
- Define appropriate responsibilities and delegate duties among fund trustees, staff and outside consultants.

"To be sure, the diverse forms of institutional investors make it impossible to develop a 'one-size-fits-all' approach to regulating fund governance," writes Peter Clapman, chairman of the committee on fund governance. "But in light of today's current system, which is rife with opportunities for abuse or mismanagement, our best-practice principles offer a road map to a more secure savings and investment environment."

The report is available at www.law.stanford.edu/clapman-report.

"Their real obligations are to act as if they are investing their own money," Rosenberg says of pension

> ***"The problem we're seeing consistently is that [pension funds] don't do sufficient investigation. They don't bring in sufficient expertise and they get blind-sided."***
>
> ***— Steve Rosenberg, attorney***
> ***The McCormick Firm***

fund executives and trustees. "Basically, what they need to do is have due diligence in place for investigating the investments in their pension fund. They should be bringing in the outside expertise of people who can really value their investments and who can decide whether they are appropriate and how to diversify."

Mangiero, whose company also assesses and advises companies on governance risks, says the key is for pension trustees to look beyond the obvious. "Even if you don't have a really fancy analytics system or a large staff of experts, you can ask traders tough questions about what keeps them up at night, what calamity could bring the fund to its knees and whether they have a chief risk officer who stays on top of things. Even now, as some pension plans realize losses, trustees and their service providers should be thinking about what could have been done differently and how risk can be better mitigated going forward. Take a look at the institutional investors with robust risk management and valuation policies and procedures. Assess existing risk and valuation best practices. Those who delay making improvements put themselves in the litigation crossfire and risk personal and professional liability." ❖

Rachel McMurdie is assistant editor of *The Institutional Real Estate Letter*.