What's Ahead in Regulatory Reform: Storm Clouds on the Horizon?

By: Carol Gilden[1]

This past year has been one of turmoil for our financial markets. Just look at the headlines. First there was the subprime mortgage meltdown, then the Bear Stearns bail out. And now public pension funds' investments in commodities future contracts are starting to gain the attention of unwanted critics, who claim those contracts are responsible for commodity price spikes. Set against this background, there have been increasing cries for regulatory overhaul and reform, with Congress stepping up and holding hearings on the cause of these events. What does this mean for public pension funds? To get a better understanding of the changes afoot, it is necessary to take a look at how these events are shaping the dialogue for regulatory reform, and the impact they can have on pension fund investments.

The ongoing crisis in our capital markets began with unsound, and speculative lending practices in the subprime market. These practices were often predatory in nature, with loans made to people who could not afford them and often without the proper credit checks. By 2005, it was estimated that one

[1/] This speech was given by Ms. Gilden at the 2008 Illinois Public Employee Retirement System Summit in Chicago, Illinois. Ms. Gilden, a former SEC enforcement attorney, is a partner in Cohen Milstein Hausfeld & Toll, PLLC's Securities Fraud/Investor Protection Group. She is the resident partner of the Chicago office, and the President of the National Association of Shareholder and Consumer Attorneys.

out of every five loans issued was subprime. And what was the role of the investment banks in these practices? The investment banks took these subprime loans and securitized them. They packaged them together, creating new investment instruments, such as mortgage back securities, or MBS's, and collateralized debt obligations, or CDO's. The securitization of mortgages led to a rapid increase in the number and amount of subprime loans. Complicit in the securitization of the mortgages were the ratings agencies, which turned a blind eye to the high risk of default inherent in these securities and their illiquid nature. As we have now come to know, the entire subprime machine was fueled by conflicts of interest, appreciating house values and low interest rates. Once, however, the housing bubble burst, prices began to drop and interest rates started climbing. Defaults shot up at an unprecedented level, and the house of cards came tumbling down, with a ripple effect throughout our economy.

Indeed, the investment banks, in which the pension fund community had been investing, were forced to disclose their exposure to the subprime mortgage market and began to take write downs. Some revealed they had created off-balance sheet entities to invest in the subprime mortgage market. Following these disclosures, the market reacted quickly with stocks spiraling down in a free fall. For example, following Citigroup's write-down of billions of dollars tied to these investments, its stock declined 60 percent, wiping out over $70 billion of market capitalization. As a result of its exposure to the subprime market, National City Corporation’s share price dropped from $35 per share, which it was trading at a year ago, to $5.60/share currently.

Clearly the subprime mortgage meltdown has had serious implications for public pension funds, which invested both in the securities of investment banks and the MBS’s and CDO’s, they issued. It has been estimated that write downs as a result of the subprime crisis totaled over $80 billion worldwide in 2007.

A leading business periodical has estimated that subprime defaults will reach a level between $200-300 billion. Further, the International Monetary Fund estimates that the financial turmoil set off by the collapse of the mortgage market could total nearly $1 trillion.

The fallout from the subprime mortgage debacle recently claimed Bear Stearns, a leading investment bank. In March of this year, Bear Stearns was teetering on the brink of financial collapse. Rather than let the institution fail, however, the Federal Reserve stepped in and in an unprecedented move, engineered a rescue whereby JP Morgan would buy Bear Stearns. The Federal Reserve also lent $29 billion to facilitate the deal. Just last week, shareholders voted to approve the purchase at the bargain basement price of $10 a share – a far cry from Bear Stearns stock price of $150 a share a year ago.

These events have led to cries for investigation and reform. Congress has been holding hearings, focusing on why government regulators, including the Federal Reserve and the SEC failed to catch and police these practices. The Treasury Department has proposed a blueprint for a regulatory overhaul, with numerous recommendations. One of the most troubling concerns the SEC, which is charged with policing and regulating our capital markets and with the protection of investors. Rather than beef up the SEC's regulatory powers, the Treasury has endorsed a sweeping plan favored by the Chamber of Commerce which would merge the SEC with the Commodity Futures Trading Commission.

As part of this proposal, the SEC would no longer regulate through rules, but rather would regulate through practice principles – which is more amorphous and less clear cut than rules based regulation. Further, the SEC would work collaboratively with regulated entities and their self-regulatory agencies. We believe this weakening of the SEC would be a mistake for the well being of our financial markets, which rely on a strong regulatory system and private action enforcement to promote market integrity and transparency. This proposal could have serious repercussions for public pension funds, which invest heavily in the securities of public companies. Instead, we believe the SEC should be provided with the necessary additional powers to regulate and restore market integrity, and that the next SEC Chair should be a strong supporter of investor protection and shareholder rights. Further, we believe the SEC should be given an increased budget with which to perform its responsibilities. These are things to watch for in the days ahead, and will be shaped by a new administration in 2009.

On other fronts, Congress has started holding hearings regarding speculation in commodities, future contracts and the CFTC's actions to regulate commodity speculation. Over the last several years, pension funds have invested billions of dollars into commodities future contracts. Pension fund investments in these contracts have lately come into question, with some attributing higher prices to speculators. While futures contracts can provide a way for pension funds to effectively control risk, critics are now suggesting that trading by pension funds should be restricted. Possible limitations include stricter limits on trade sizes or positions, higher margin requirements, or even regulations that make commodity speculation an unsuitable investment for pension funds. Senator Lieberman has said he plans to draft legislation and hold a hearing with top officials from the CFTC and various pension funds to critique his draft legislation. Public funds need to be engaged in this debate as this proposed legislation takes form.

Other areas that have an impact on public pension funds and their investments involve the financial reporting of public companies. It is estimated that public funds and other institutional investors own approximately 75% of all public companies. The accuracy of financial reporting is at the heart of market integrity for these public companies. In this regard, an Advisory Committee to the Treasury Department was formed to develop recommendations relating to the auditing profession. The Advisory Committee on the Auditing Profession issued a draft report a few weeks ago, which contained numerous recommendations. Some of the recommendations, the pension fund community should get behind, and others, the pension fund community should be wary of.

For example, the Draft Report recommends that the fraud detection and prevention skills of auditing firms be strengthened, and lays out a number of recommended steps to do so. The report also urges the SEC to amend Form 8-K so that it will require companies to always provide the reason for an auditor's departure. Another well taken recommendation is to improve the corporate governance of auditing firms through advisory boards with independent board members that have meaningful governance responsibilities. Certainly, these provisions are encouraging.

Troubling, however, is a provision asking the SEC and PCAOB (Public Company Accounting Oversight Board) to clarify the auditors' role in detecting fraud under current accounting standards. The Advisory Committee claims this is necessary because of what they call an expectations gap between the public's expectations regarding auditor responsibility for fraud detection and the auditors' performance in that regard. Addendums and amendments to the Draft Report should be watched for, and pension funds should not hesitate to speak up and comment on those provisions which could adversely affect their interests.

Also of note are several studies commissioned in the last year which claim existing governmental regulations and securities litigation are hurting the ability of our capital markets to attract new listings. Public funds should be on alert to such claims since the premises underlying them are faulty and are being used in a thinly veiled effort to rollback shareholder protections.

Another issue of concern is “say on pay”. Last year legislation requiring companies to submit executive compensation to a non-binding shareholder vote was passed by the House. The bill has since been derailed in the Senate. Say on pay is desperately needed. As the most recent market scandals demonstrate, the CEO’s of the firms most responsible for causing the subprime mortgage crisis collected hundreds of millions of dollars in pay last year. This highlights the need for further reform to protect investors.

Lastly, in the remaining days of this administration and certainly in the administration to come, the composition of the SEC Commission and their views will be critical to public pension funds. Commissioners have 5 year staggered terms. Hearings are being scheduled on replacements for three of the four seats. Given the role of the SEC as the watchdog for our financial markets, the composition of the Commission will continue to have a profound effect on shareholder rights and investor protections in the days to come.

In conclusion, with all the potential changes underway, pension funds should stay closely attuned to developments in legislation being considered in Washington.

Postscript: The nominees to the vacant SEC seats, Elisse Walter, Luis Aguilar and Troy Paredes, were confirmed by the United States Senate, thereby providing the SEC with the full complement of Commissioners. Further, the Treasury Department's Advisory Committee on the Auditing Profession issued an Addendum to its Draft Report, which among other things, sought comment on potential auditor liability reforms. In response to the comments generated, the Advisory Committee decided not to issue a recommendation, and will instead issue a statement setting forth various views on this issue. Ms. Gilden is opposed to auditor liability reforms and wrote the Treasury Department on behalf of the National Association of Shareholder and Consumer Attorneys, of which she is President, stressing the need for strong investor protection. (Copies of the letter are available on request.) The pension fund community should continue to monitor regulatory developments impacting its rights, and should not hesitate to express its views on these matters.