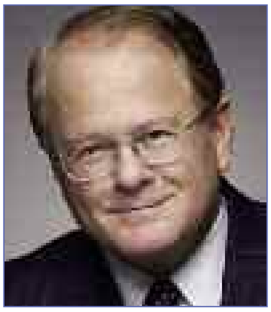
Market volatility leaves room for risky practices



Thomas Dubbs
Senior Partner
Labaton Sucharow LLP

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Standard & Poor's recent downgrade of the United States' credit rating from AAA to AA+ has prompted an increased volatility in the markets, and inspired fears that a second worldwide financial crisis may be upon us. Pension plans in both the United States and Europe, many of which were already facing long-term funding shortfalls, must now deal with additional challenges in this destabilised environment.

The major credit rating agencies, including Standard & Poor's, have received heavy criticism in recent years. During the buildup to the 2007 credit crisis, they frequently awarded high ratings to complex investments based on risky subprime mortgages. These undeservedly-good ratings helped support the housing bubble and led investors to unwittingly gamble on what amounted to junk bonds (or worse). Inevitably, the value of these investments plummeted. In response, a number of lawsuits were filed in 2009 in the United States against Standard & Poor's and the other credit rating companies, including federal actions in Ohio (by the Ohio Attorney General) and in New York, and state actions in Connecticut (by the Connecticut Attorney General) and in California by the California Public Employees Retirement System ("CalPERS"). In all four cases, the parties are awaiting decisions by the courts.

In addition, allegations were brought against the ratings agencies in federal court in New York by the Wyoming Retirement System and various Union Funds as part of the *Lehman Securities Litigation*, alleging that they were acting, in effect, as underwriters. The Second Circuit, however, recently upheld the dismissal of the suits against the ratings agencies in the Lehman, case holding that "the Securities Act of 1933 does not reach further to identify as underwriters persons who provide services that facilitate a securities offering, but who do not themselves participate in the statutorily specified distribution-related activities." However, the rejection of this rather aggressive theory that Standard & Poor's is "really an underwriter" is not necessarily significant. The action is in the two State Attorney General cases and the case brought by CalPERS, the largest US pension scheme. Now, by reducing the United States' credit rating, Standard & Poor's may have contributed to a second crisis, as credit markets across the globe tighten in response.

If the United States economy slows, there may be a secondary effect in Europe. Already on shaky ground because of the sovereign debt crisis, Europe's economies are in worse shape than in the run-up to the 2007 financial crisis and therefore are in correspondingly more danger. Greece, Ireland and Portugal are in debt meltdowns and there are also calls for Spain and Italy to be bailed out. A second recession in the United States would only exacerbate the economic situation in Europe, possibly expanding the debt crisis even further.

Pension funds, which are already struggling with reduced returns, have seen the value of their portfolios further reduced since the S&P downgrade. In the Netherlands, Stichting Pensioenfonds ABP, the world's third-largest pension fund, has fallen below a 100 per cent funding ratio, putting its capacity to make future payments at risk. This is in spite of the fact that in response to the 2007 financial crisis, ABP changed its asset allocation strategy to be more conservative, holding more bonds and blue chip stocks.

Contrary to Standard & Poor's opinion, United States bonds may still be a very safe investment. To date, Treasury Bills have not seen a hit to their trading volume or an increase in the yields. Moreover, Moody's Investor Services and Fitch Ratings both re-affirmed their AAA ratings for the US, showing that the credit rating downgrade is far from unanimous. Further, the economic weaknesses in many Western countries and ongoing political crises in many areas of the world seem to be keeping US bonds attractive to international investors. Indeed, the most significant effect that the reduction of the US credit rating may have is not on the United States itself, but on Europe, by potentially tightening credit to Europe at a time when the EU and its member states need free access to the credit markets.

This kind of extreme market volatility that we have experienced of late is also an attractive environment for corporate fraud. Investors, especially institutional investors, need to ensure that those companies in which they hold stock are not engaging in fraudulent or needlessly risky business practices. This requires active engagement by shareholders and a willingness to be involved in corporate governance initiatives.

Further, when companies *do* engage in fraud, investors must be willing to seek repayment of damages through the law. Pension funds simply can not afford to passively lose money due to fraud, especially in the current environment of economic uncertainty. The dangers of a volatile market are more than enough – pensioners do not need to fear that their retirement funds will disappear because of unethical actions by the executives of the very companies in which they have invested.