

HEINONLINE

Citation: 7 Minn. J. Global Trade 211 1998



Content downloaded/printed from
HeinOnline (<http://heinonline.org>)
Wed Nov 11 17:22:03 2015

- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at <http://heinonline.org/HOL/License>
- The search text of this PDF is generated from uncorrected OCR text.
- To obtain permission to use this article beyond the scope of your HeinOnline license, please use:

[https://www.copyright.com/cc/basicSearch.do?
&operation=go&searchType=0
&lastSearch=simple&all=on&titleOrStdNo=1944-0294](https://www.copyright.com/cc/basicSearch.do?&operation=go&searchType=0&lastSearch=simple&all=on&titleOrStdNo=1944-0294)

Emerging Market Debt Instruments Play Siren Song for Pension Plans

Ruth Rosauer

Pension fund managers have a fiduciary responsibility to manage assets for the secure retirement of the beneficiary. Under traditional standards of fiduciary duty, investments in highly indebted nations would have constituted a breach of the fiduciary's duty to not speculate with trust assets. However, under current ERISA (Employee Retirement Income Security Act) guidelines, fiduciaries may include investments in emerging nation debt instruments. This Note argues that the country risk component of some emerging nation debt instruments renders them too speculative for the unlimited investment of pension funds.

Part I of this Note begins with an overview of the international debt crisis and corresponding U.S. bank difficulties of the latter part of the 20th century. It describes many of the investment risks that arise when debtors and creditors are domiciled in different nations, and identifies securitization as a relatively new financing technique that disguises these risks. Part II discusses retirement funding for U.S. workers and regulation of pension funds. In Part III, this Note proposes that the United States should enact legislation which both recognizes and limits the extent of the interrelationship between the capital needs of developing countries and a pension plan manager's quest for high rates of return. This Note concludes that such legislation would be beneficial to both debtors and investors.

I. OVERVIEW OF DEBT CRISIS

In the continuum of relationships between entities who lend money and those who borrow it, the party extending credit is variously known as an investor, lender, banker, or creditor. The distinction between these roles is largely based on the perceived creditworthiness of the borrower. Credit arrangements can take a variety of forms, including bonds and loans; collectively they

are known as "instruments."¹ This supply of debt instruments is referred to variously in this Note as emerging market debt, developing country debt, and Third World debt.

A. THE SIGNIFICANCE OF EMERGING NATION DEBT

In the world of international finance, where a fluctuation of a few basis points² is cause for a press release, it is possible to lose sight of the importance that debt instruments have for the underlying trade, investment, and development needs of the sovereign nations who are the debtors. For many nations, external debt is a major component of public investment and current consumption, including imports.³

Fundamentally, debts incurred by the sovereign nation are the responsibility of its citizens. Debt repayment is inextricably linked to their standard of living and can mean, in some instances, the difference between life and death.⁴ Emerging nation debt, sanitized though it may be in the autoclave of global financial markets and lengthy contract negotiations in boardrooms, remains a potentially destabilizing political force.⁵

Third World debt is also important to the economies of creditor nations, not just to those citizens and institutions which have directly invested money in emerging market debt instruments. For example, since American jobs depend on exports,⁶

1. Emerging market debt instruments have been defined as "all debt obligations and equity interests . . . owed, issued or guaranteed by a public or private sector entity located in a country that is not a member of the . . . OECD." EMERGING MARKETS TRADERS ASSOCIATION, CODE OF CONDUCT Sched. A (1992).

2. A basis point represents 1/100 of one percent. For example, if investment A yields a return of 7.16% and investment B yields a return of 7.18%, there is a difference of two basis points. MARCIA STIGUM, MONEY MARKET CALCULATIONS: YIELDS, BREAK EVENS, AND ARBITRAGE 19 (1981).

3. Funds can be used for immediate consumption or to finance the building of infrastructure and productive capacity. Either use will increase demand for imports. Public sector borrowing is also used to finance social investments such as education and health programs. IRVING S. FRIEDMAN, THE WORLD DEBT DILEMMA: MANAGING COUNTRY RISK 86-87 (1983).

4. According to UNICEF, 500,000 Third World children died in 1987 in order to pay the interest on the national debt of their home countries. Nicholas Eberstadt, *UNICEF Cries Wolf*, WALL ST. J., Sept. 28, 1990, at A14.

5. In August and September of 1983, after a reduction in food subsidies made necessary by IMF-imposed austerity measures, hungry Brazilians took to looting supermarkets for food. See DARRELL DELAMAIDE, DEBT SHOCK 213-19 (1984).

6. The U.S. Under Secretary of Commerce estimated that the drop in Mexican imports from 1981 to 1982 due to the debt crisis resulted in the loss of as many as 250,000 U.S. jobs. VINOD K. AGGARWAL, INTERNATIONAL DEBT THREAT: BARGAINING AMONG CREDITORS AND DEBTORS IN THE 1980s 36 (1987).

the debt crisis has significant domestic policy implications for the United States.⁷

B. DEBTOR-CREDITOR RELATIONS

1. *Historical Perspective*

The "Buy Now, Pay Later" approach is not a phenomenon new to the late 20th century; it has been used for over a century to finance international trade and development.⁸ Since loans from one country to another are inherently riskier than loans between entities within the same country, there have been many instances of loan default.⁹ Creditors have tried a variety of approaches as remedies against foreign nations who failed to honor their obligations for timely debt servicing, with varying degrees of success.¹⁰

Several factors converged¹¹ in the late twentieth century to cause a Third World debt crisis that threatened to undermine

7. Benjamin J. Cohen, *High Finance, High Politics, in* UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD 107 (Richard E. Feinberg & Valeriana Kallab, eds., 1984) (noting that debt rescheduling takes more international negotiation time and effort than any other issue).

8. Enrique R. Carrasco & Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis*, 34 COLUM. J. TRANSNAT'L L. 539, 546 (1996).

9. *Id.* at 547. Latin American governments defaulted on loan payments in the 1820s, 1870s, and 1930s. Andrew Bary, *The Lust for Latin Debt: Yield-Seeking Funds Downplay Perils in Brady Bonds*, BARRON'S, Aug. 16, 1993, at 8, 9. Between 1970 and 1995, 30 countries defaulted at least once on their debt. *Room for Improvement*, THE ECONOMIST, July 15, 1995, at 54.

10. European powers tried to physically administer the economic affairs of Venezuela in 1902 when Venezuela was delinquent in its loan payments. They were stopped by Theodore Roosevelt's willingness to use the U.S. Navy. When the Dominican Republic defaulted on its debts to the United States in 1904, Theodore Roosevelt placed an American receiver-general in charge of Dominican revenues and arranged for 55% of Dominican Customs receipts to go toward the payment of its external debt. Similar interventions by the United States occurred in Haiti, Honduras and Nicaragua. Carrasco & Thomas, *supra* note 8, at 547-48, n.24. The United States froze Russian assets in the United States when the Bolsheviks reneged on Russian debts in 1917. Even so, it was not until 1959 that creditors were repaid, and then it was only ten cents for every dollar. Linda Sandler, *U.S. Banks Prepare for the Possibility of Third-World Debt Repudiation*, WALL ST. J., July 6, 1984, at 17.

11. The 1970s witnessed an unprecedented increase in world interest rates and a sharp rise in both oil prices and debt build-up by the debtor nations. JEFFREY D. SACHS, *DEVELOPING COUNTRY DEBT AND THE WORLD ECONOMY* 7-8 (1989); FRIEDMAN, *supra* note 3, at 53. Prices for commodities, the primary source of income for developing nations' debt payments, dropped as much as 33% from the 1970s to 1982. Developing nations then had to borrow at high interest rates at a time when their exports were fetching less on the world mar-

the world's economy.¹² Outstanding U.S. bank loans to just the seventeen most highly indebted developing nations were equivalent to 130% of the lending banks' capital and reserves in 1982.¹³ Developing countries were paying as much as 50% of their export earnings in interest payments on their loans.¹⁴

In August of 1982, Mexico announced that it could not service its debt.¹⁵ Brazil, Argentina, Bolivia, and Venezuela quickly followed suit.¹⁶ Shortly thereafter many other nations fell into arrears or stopped making payments on their loans.¹⁷

U.S. commercial banks and the World Bank¹⁸ initially dealt with this crisis by lending the same debtors more money to make their interest payments on the original debt and ignored the underlying economic factors that signaled these loans were in long-term difficulty.¹⁹ Lending money to pay interest merely increased developing nations' debt loads and did not increase their capacity to ever repay the principal.²⁰

ket. JOHN H. MAKIN, *THE GLOBAL DEBT CRISIS: AMERICA'S GROWING INVOLVEMENT* 221 (1984).

12. A Dutch economist for Morgan Guaranty likened Mexico's decision to suspend debt payments in 1982 to "an atom bomb being dropped on the world financial system." DELAMAIDE, *supra* note 5, at 10. Other analysts warned that the financial system in many industrialized countries would collapse due to the Third World debt crisis. Lindley H. Clark, Jr., *Speaking of Business: Let's Merge the World Bank and the IMF*, WALL ST. J., Jan. 4, 1990, at A12; Peter Torday, *IMF Head Accuses Banks of Hurting Debt Crisis Strategy*, WALL ST. J., May 11, 1988, at 43. The Third World and Eastern European countries had combined foreign debts of \$626 billion in 1982, triple the amount in 1971. By the end of 1982, about 40 nations had substantial payments problems, threatening the world banking system. DELAMAIDE, *supra* note 5, at 7-8.

13. WILLIAM R. CLINE, *INTERNATIONAL DEBT REEXAMINED* 71 (1995).

14. Carlos Andres Perez, *Venezuela's Burden of Debt and Violence*, WALL ST. J., Mar. 17, 1989, at A15.

15. Phillip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings*, 64 *FORDHAM L. REV.* 2701, 2708-09 (1996).

16. *Id.*

17. *Id.*

18. The World Bank, which had previously confined its lending to infrastructure projects, made loans that were used to pay off overdue interest to commercial banks. Paul Craig Roberts, *The World Bank is Adding Fuel to the Debt Tinderbox*, *BUS. WK.*, Nov. 7, 1988, at 21.

19. DELAMAIDE, *supra* note 5, at 25.

20. *Id.*

2. *International Lending Supervision Act of 1983*

In 1983, Congress acknowledged the role of U.S. banks in the Third World debt crisis when it passed the International Lending Supervision Act (ILSA).²¹ Congress declared that:

It is the policy of the Congress to assure that the economic health and stability of the United States and the other nations of the world shall not be adversely affected or threatened in the future by imprudent lending practices or inadequate supervision. This shall be achieved by strengthening the bank regulatory framework to encourage prudent private decisionmaking and by enhancing international coordination among bank regulatory authorities.²²

Legislators had two goals in mind when they enacted ILSA. They wanted to control, regulate, and supervise lending practices of creditor banks in the United States, yet encourage a continued, albeit reduced, flow of capital to debtor nations.²³ Five provisions in ILSA supervise and regulate commercial bank lending abroad: (1) development of an early warning system to alert banks to country risk and the adequacy of bank capital to meet that risk;²⁴ (2) stricter accounting rules about international loan fees;²⁵ (3) increased reporting requirements of banks' exposure to country risk;²⁶ (4) increased cooperation between U.S. agencies and other international regulatory agencies;²⁷ and (5) requirements for special reserves for specific types of international loans.²⁸ Furthermore, ILSA requires a bank to create Allocated Transfer Risk Reserves (ATRRs) or, alternatively, to "write-down" the value of the loan every time it lends to a very heavily indebted country.²⁹

Legislators thought that banks would lend more responsibly if they were subject to more scrutiny.³⁰ Thus, ILSA requires

21. International Lending Supervision Act of 1983 (ILSA), 12 U.S.C.A. § 3901-12 (Supp. II 1984).

22. *Id.* at § 3901(a)(1)(2).

23. Lyle B. Vander Schaaf, Note, *The International Lending Supervision Act of 1983: Has it Had an Effect on the Latin American Debt Crisis?*, 2 AM. U.J. INT'L L. & POL'Y 689, 696 (1987).

24. 12 U.S.C.A. § 3903, *supra* note 21.

25. *Id.* at § 3905.

26. *Id.* at §§ 3906, 3912.

27. *Id.* at § 3911.

28. *Id.* at § 3904. See Robert R. Bench & Dorothy A. Sable, *International Lending Supervision*, 11 N.C. INT'L L. & COM. REG. 427, 428 (1986).

29. In practice, the regulatory agencies only required banks to use ATRRs for a very few highly-indebted countries such as Nicaragua, Bolivia, Sudan, Poland, and Zaire. Vander Schaaf, *supra* note 23, at 697-99.

30. Salvatore O. Franco, Note, *Should Institutional Investors Play a Role in Shaping Mexico's Economic Policy?*, 16 N.Y.L. SCH. J. INT'L & COMP. L. 489, 510 (1996).

banks to submit quarterly reports to federal regulatory agencies and the public.³¹ The purpose of these reports is to allow depositors and investors to "assess the degree of diversification and risk involved in bank investment portfolios."³²

ILSA increases the authority of the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller to issue capital directives and cease and desist orders to banks who fail to maintain adequate capital reserves for their international loans.³³ The administrative authority was strengthened by a 1991 case from the Fifth Circuit Court of Appeals, *Bank of Coushatta*.³⁴ ILSA has been more successful in enforcing remedial measures for those banks who have taken on excessive international risk than it has been in eliminating high country risk from the lending portfolio.³⁵

C. FINANCIAL MARKET RESPONSE TO THE DEBT CRISIS

1. *Brady Bonds*

Mexico completed the first "Brady" bond deal in 1990.³⁶ It pooled together its external debts, repackaged them, and sold them to investors around the world.³⁷ The proceeds from the sale of Brady bonds retired large chunks of Mexico's old higher interest debt to commercial banks.³⁸ The Brady bonds were more palatable to international investors than Mexico's sovereign debt because the principal and first year of interest were collateralized with U.S. Treasury zero-coupon bonds.³⁹ The collateral is held by the Federal Reserve Bank of New York.⁴⁰

31. Vander Schaaf, *supra* note 23, at 702.

32. *Id.*

33. Stephens B. Woodrough, *Capital Directives: Obey 'Em or Else!*, AM. BANKER, June 25, 1991, at 4.

34. FDIC v. Bank of Coushatta, 930 F.2d 1122 (5th Cir. 1991) (holding that a capital directive could be issued without a hearing first and was not subject to judicial review).

35. Note, *The Policies Behind Lending Limits, an Argument for a Uniform Country Exposure Ceiling*, 99 HARV. L. REV. 430, 448 (1985) [hereinafter *Argument for Exposure Ceiling*].

36. LEHMAN BROTHERS, BRADY BOND MARKET HANDBOOK 2 (1995). Brady bonds take their name from the former Secretary of the U.S. Treasury, Nicholas Brady, who encouraged banks to participate in this form of financing. John E. Rogers & Jonathan R. Hodes, *Using the "Brady Bond" Approach in Mexican Corporate Financing*, 2 MEX. TRADE & L. REP. NO. 4, at 5 (Apr. 1990).

37. Power, *supra* note 15, at 2720-22.

38. *Id.*

39. *Id.*

40. Edward M. Truman, *The Mexican Peso Crisis: Implications for International Finance*, 82 FED. RESERVE BULL. 199, 202 n.9 (1996).

The Brady bond market has expanded considerably since its inception.⁴¹ As of April 1997 the value of outstanding Brady bonds totaled about \$140 billion.⁴² Trading volume was \$671 billion in the first quarter of 1997.⁴³

2. Secondary Market for Emerging Nation Debt

A secondary market for Third World sovereign and private sector debt started in 1982 as an informal network among commercial and investment bankers.⁴⁴ There was no formal reporting system for trades, and most trading was done privately.⁴⁵ The LDC debt market is not comprehensively regulated.⁴⁶ Insider trading has already occurred.⁴⁷ Secondary market manipulation can have serious repercussions for the debtor nation as well as the investors.⁴⁸ Nevertheless, the market continues to grow; in 1997, the total reported Third World debt market was \$1.16 trillion.⁴⁹

41. As of March 1995, 12 countries had issued Brady bonds: Argentina, Brazil, Bulgaria, Costa Rica, Dominican Republic, Jordan, Mexico, Nigeria, Philippines, Poland, Uruguay, and Venezuela. LEHMAN BROTHERS, *supra* note 36, at 6.

42. Mary D'Ambrosio, *Brady Bonds: Thanks for the Memories*, LDC DEBT REP., Apr. 21, 1997, available in 1997 WL 7939312.

43. *Bradys No Longer Top Dog, Says EMTA*, LDC DEBT REP., May 19, 1997, available in 1997 WL 7939432.

44. Michael Chamberlin et al., *Sovereign Debt Exchanges*, 1988 U. ILL. L. REV. 415, 418 n.18 (1988).

45. James R. Kraus, *Trading in Third World Debt Soars as Investors Rush In*, AM. BANKER, Sept. 17, 1991, at 10.

46. EMERGING MARKETS TRADERS ASSOCIATION, *supra* note 1, at 1. The Securities and Exchange Commission (SEC) has jurisdiction over some of the bonds, but over none of the loans traded. The Federal Reserve focuses on regulating the banks that make the loans, not on the loans themselves. Kelley Holland, *The LDC Debt Market: It's a Jungle Out There*, BUS. WK., Mar. 15, 1993, at 86, 87.

47. The Federal Reserve Board brought proceedings against Daniel Young, former vice president of Manufacturers Hanover Trust Company, for alleged violations of U.S. banking law in connection with trading Colombian debt. Tom Mashberg, *Two Indicted in Latin Loan Deal*, BOSTON GLOBE, May 15, 1993, at 37.

48. The Dart family acquired \$1.4 billion of Brazilian debt and then in 1994 demanded that Brazil accelerate its payment of principal when it failed to make timely debt service payments. At that time the Dart family was Brazil's fourth largest creditor. Although the court dismissed the Darts' claim for acceleration, it upheld their breach of contract claim for \$60 million. Brazil was forced to alter its fiscal strategy as a result. Power, *supra* note 15, at 2747-51.

49. D'Ambrosio, *supra* note 42.

D. EMERGING NATION DEBT INVESTMENT TRENDS

1. *Third World Debt Problems Persist*

It is tempting to think that due to an improved international economy, the end of the oil crisis, lower international interest rates, and systemic changes in loan intermediation the debt crisis of the 1980s will not recur.⁵⁰ Although the average debt service to export earnings ratio has been falling for developing country debt through the 1990s,⁵¹ developing countries owed \$2.2 trillion in 1997.⁵² The market for this debt remains volatile, however, due to country risk factors, lack of comprehensive regulation of the market, the potential for political instability in debtor nations caused by austerity measures imposed by the International Monetary Fund (IMF), and independent external events such as world interest rates, and the price of oil and other commodities.⁵³

The Mexican Peso Crisis of 1994 is proof that the risk of investing in Third World countries persists.⁵⁴ Mexico did enact most of the reforms urged by economists after its major debt crisis of 1982. It privatized many industries and utilities, improved tax collection, and reduced its deficit.⁵⁵ It attacked its inflation problem and pegged its exchange rate to that of the

50. "[B]y 1992-93 the debt crisis was over as a major threat to industrial country financial systems . . ." CLINE, *supra* note 13, at 87.

51. *Emerging Market Indicators*, ECONOMIST, APR. 6, 1996, AT 110.

52. Nick Nuttall, *Earth Summit Backtracks on Aid to the Have-Nots*, TIMES (LONDON), JUNE 28, 1997, at 16.

53. See James North, *Latin American Lands Are Burros, Not Tigers, Plodding Forward, but Ready to Jump Back*, BARRON'S, Aug. 4, 1997, at 47. For a discussion of country risk factors see Lawrence Summers, *Summers on Mexico: Ten Lessons to Learn*, THE ECONOMIST, Dec. 23, 1995, at 46. World interest rates were at unusually low levels in 1992-93. Although LIBOR (London InterBank Offering Rate) was at 14% in 1979-82, in 1992-93 it was only 3.5%. Cline, *supra* note 13, at 473-77. Interest rates are likely to rise. *Id.* The collapse of oil prices in 1986 had a significant impact on global debt strategies. *Id.* at 125. The World Bank expects real oil prices to rise at an annual rate of 2.2% from 1994 to 2002. *Id.* at 477-78. Commodity prices are an important factor in a country's ability to generate export revenue. *Id.* at 113-15.

54. See generally Truman, *supra* note 40. On January 24, 1995, the Mexican government was unable to raise short term capital, even when it tried to compensate for the higher perceived risk by raising interest rates 7% from the week before. Two of the causes of this crisis were higher interest rates in the United States, which made Mexican investments less attractive, and political instability.

55. James D. Humphrey II, Note, *Foreign Affairs Powers and "The First Crisis of the 21st Century": Congressional vs. Executive Authority and the Stabilization Plan for Mexico*, 17 MICH. J. INT'L L. 181, 183 (1995).

United States.⁵⁶ In addition, it reduced trade barriers and began political reform.⁵⁷ Furthermore, Mexico — as the United States' third largest trading partner — was considered by many to be "too important to fail."⁵⁸ The Mexican Peso Crisis of 1994, therefore, took many by surprise. Despite a massive loan from the IMF, the peso fell to its lowest level in history, and reserves were down to \$2 billion when President Clinton announced an emergency loan package on January 31, 1995.⁵⁹ The United States and the IMF will not always be able to offer such tremendous aid to debtor nations.⁶⁰ The Federal Reserve has warned that investors in foreign debt instruments should be more careful in the future.⁶¹

2. *Evolving Instruments*

Brady bonds were originally issued with collateral such as U.S. Treasury bonds,⁶² which reduced the risk for holders of Third World debt.⁶³ Unfortunately, the media has a tendency to simply identify Brady bonds with U.S. Treasuries;⁶⁴ therefore, unwary investors may unwittingly buy non-collateralized Brady bonds under the assumption that they are completely safe. While it is true that Brady bonds are the safest investment in the emerging nation debt market, it is only their principal that is fully collateralized.⁶⁵

The Brady bond denominated in U.S. dollars is not the only foreign debt instrument drawing the interest of American investors. Mexico has converted many of its outstanding Brady bonds into uncollateralized Eurobonds⁶⁶ denominated in pesos rather than dollars.⁶⁷ Debt denominated in local currency accounts for

56. *Id.*

57. *Id.*

58. *Id.* at 190.

59. *Id.* at 196. The Mexican Peso Crisis of 1994 began in mid-December 1994. Truman, *supra* note 40, at 204-205.

60. Truman, *supra* note 40, at 203.

61. *Id.*

62. Rogers & Hodes, *supra* note 36, at 5.

63. CLINE, *supra* note 13, at 479.

64. "When a country's foreign debt is converted into so-called Brady bonds, which are U.S. Treasury securities . . ." John C. Edmunds, *Securities: The New World Wealth Machine*, FOREIGN POL'Y, Sept. 11, 1995, at 128.

65. Rogers & Hodes, *supra* note 36, at 6.

66. Although Eurobonds must be issued in Europe, they can be denominated in any currency. Any nation can issue Eurobonds, as long as they are issued "outside the confines of any national capital market." Stigum, *supra* note 2, at 184.

67. Daisy Maxey, *The Standouts in a Drab Year*, BARRON'S, Dec. 30, 1996.

63% of all emerging nation debt.⁶⁸ Emerging nation debt portfolio managers are buying these investments to enhance their portfolios because the yields are better and they reduce the correlation to U.S. Treasuries that collateralized Brady bonds have.⁶⁹

3. *The Changing Investor*

Holders of Third World debt are no longer just large commercial banks with staff economists to provide country risk analysis.⁷⁰ Americans with IRAs and 401(k) funds are now investing in emerging market funds.⁷¹ Large pension funds began investing in emerging nation debt in 1991.⁷² Mutual funds provide opportunities for individual investors to own small pieces of emerging market debt.⁷³ High yields relative to U.S. Treasuries are tempting them to do so.⁷⁴ In 1996, emerging market debt yielded returns of 30% to 40%, compared with a yield on 30-year U.S. Treasuries that was less than 7% during that year.⁷⁵ Total U.S. tax-exempt money in emerging market debt instruments was more than \$20 billion in 1995.⁷⁶ Investors' perception of the market has changed. Now that Brady bonds have been around for more than a decade, there is a general belief that "emerging markets instruments are simply another type of high-yielding, high-risk asset" in a portfolio.⁷⁷

4. *Securitization*

Securitization is a complex financing arrangement whereby an "issuer" raises money by selling the right to receive future

68. Bill Hinchberger, *Local Heroes: Investor Interest in Latin Currency Debt is Running High*, INSTITUTIONAL INVESTOR, July 1, 1997, at 137, 141.

69. *Id.*

70. When making international loans, banks hire professionals to monitor country risk. FRIEDMAN, *supra* note 3, at 9.

71. Humphrey, *supra* note 55, at 191; Kraus, *supra* note 45, at 10.

72. Kraus, *supra* note 55, at 10.

73. In 1996 there were 21 mutual funds primarily invested in emerging market bonds. Maxey, *supra* note 67.

74. Bary, *supra* note 9, at 54.

75. The J.P. Morgan Emerging Markets Bond Index Plus yielded 39.3%, and the GMO Emerging Country Debt Fund returned 66.3% for 1996. *Healthy '97 Rise Won't Rival Huge '96 Gains*, LDC DEBT REP., Jan. 6, 1997, available in 1997 WL 7939045.

76. *Emerging Markets Beckon Pension Funds*, LDC DEBT REP., Sept. 23, 1996, available in 1996 WL 5559953 at *2.

77. Ali Naqvi, *Diversification Means Staying Power*, LDC DEBT REP., Sept. 23, 1996, available in 1996 WL 5559961.

monies to be generated from a group of assets.⁷⁸ The issuer bundles together assets that are similar in some respect and are expected to produce a stable cash flow.⁷⁹ The issuer sells its right to receive this future income into a pool which in turn sells shares to investors through private placements or public offerings.⁸⁰ If the securitization is successful, the issuer gets immediate liquidity,⁸¹ and the investors receive a steady stream of income from the pool.⁸²

Securitization began in 1970 with the issuance of "Ginnie Maes."⁸³ Since then, the securitization market has exploded, as evidenced by more than \$1.9 trillion in securitizations outstanding in 1994.⁸⁴ Securitized investments are now offered for a variety of assets such as automobile loans, oil, and prospective soybean crops.⁸⁵ Market acceptance of emerging nation securitizations has been enthusiastic.⁸⁶ About \$8 billion in securitizations originated in emerging markets in 1996.⁸⁷

Securitization has altered the international economic system.⁸⁸ It is a revolutionary concept in financing because it takes one entity and splits it into two credit ratings: one for the original issuer and another for the securitization.⁸⁹ This split is of immense value to an issuer located in a nation with a low credit rating because securitization offers the potential to access capital at a lower cost.⁹⁰ Credit rating agencies had a long-standing practice of not awarding any entity within a nation a better

78. Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1067 (1996).

79. Charles E. Harrell, et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW 885, 887 (May 1997).

80. *Id.*

81. *Id.* at 886-87.

82. Hill, *supra* note 78, at 1068.

83. Ginnie Maes are bite-sized pieces of a bundle of residential mortgages insured by the Federal Housing Administration and the Veterans Administration. Alfred J. Puchala, Jr., *Securitizing Third World Debt*, 1989 COLUM. BUS. L. REV. 137, 140 (1989).

84. Hill, *supra* note 78, at 1062.

85. Suzanne Woolley, *What's Next, Bridge Tolls? Almost Any Risk Can Be Securitized — But Quality May Be Iffy*, BUS. WK., Sept. 2, 1996, at 64, 65.

86. An Argentinean oil company issued a securitization in January 1994 that was oversubscribed by 300%. *Junk Bonds: Emerging, Converging*, THE ECONOMIST, Jan. 29, 1994, at 79 [hereinafter *Junk Bonds*].

87. Aaron Elstein, *Banks Joining Parade of Buyers of Asset-Backed Paper From Third World*, AM. BANKER, Nov. 13, 1996, at 32.

88. Edmunds, *supra* note 64, at 118.

89. Harrell, *supra* note 79, at 887.

90. *Id.*

credit rating than the nation itself.⁹¹ In 1993 Standard & Poor's departed from this tradition when it rated a securitization indirectly issued by an agency of the Mexican government higher than Mexico's foreign currency senior debt.⁹²

There are still risks to investments in securitizations. The issuer may declare bankruptcy,⁹³ or the asset may not produce the projected revenue.⁹⁴ Even if the issuer lives up to its promised potential, there is the possibility that the sovereign nation will expropriate the commodity.⁹⁵ A sovereign government also has the right to change the regulations applicable to a certain business.⁹⁶

Securitization of Third World debt is a very new financing technique, and the global economy has been relatively good since its inception.⁹⁷ No one knows, however, how risky these investments will be in an economic downturn.⁹⁸ Eventually, securitization instruments will grow in importance as a means of financing international trade and infrastructure projects.⁹⁹ Bankers, investors, and rating agencies will become more sophisticated in assessing the risk of these instruments.¹⁰⁰ In the meantime, emerging nation securitizations continue to be high risk investments. Securitizations are considered to be in the same league as junk bonds, even by their proponents.¹⁰¹

91. *Junk Bonds*, *supra* note 86, at 79.

92. Harrell, *supra* note 79, at 890.

93. Hill, *supra* note 78, at 1078 (explaining that, upon bankruptcy, the conveyance possibly will not be respected).

94. Marissa C. Wesely, *Securitizing Project Debt*, in NEW DEVELOPMENTS IN SECURITIZATION 1996, 747 P.L.I. COM. L. & PRAC. 335, 376 (Dec. 1996).

95. *Id.* at 381. It is possible for investors to purchase insurance from the Overseas Private Investment Corporation to cover currency risk, expropriations, and political violence. Harrell, *supra* note 79, at 903. A related problem is that it is sometimes difficult to tell the difference between private and public assets in developing countries. For example, in 1996, Citicorp negotiated a securitization involving the future telephone bills in Pakistan. The Pakistani government, however, because it owned the phone company, forbade the selling of what it considered a national asset. The investors and Citicorp are still trying to settle the matter. Aaron Elstein, *Investors Leery of 'Future Flow' Securities*, AM. BANKER, June 26, 1997, at 26.

96. For example, one securitization soured when Colombia added a 20% surcharge and revoked a power project's tax exemptions. *Dam Good Business This*, *Chaps*, THE ECONOMIST, Aug. 26, 1995, at 61.

97. North, *supra* note 53, at 48.

98. *Id.* See also Elstein, *supra* note 87, at 32 (stating that because the Latin American economy has been strong since securitization gained popularity, it is unclear how securitizations will react in an economic slowdown).

99. Wesely, *supra* note 94, at 387-88.

100. *Id.*

101. See generally Puchala, *supra* note 83, at 143-47.

5. Lack of Transparency

Securitization is not the only stumbling block to transparency in the emerging nation debt market. Investors can unwittingly increase their investments in developing countries by buying bank stock¹⁰² or mutual funds.¹⁰³ Mutual funds are increasing their holdings of higher risk emerging nation debt, and unsophisticated mutual fund investors may not be aware of the type of risk they are buying.¹⁰⁴ The Securities and Exchange Commission (SEC) is concerned because many mutual funds now invest substantial parts of their portfolios in investments, such as emerging nation debt, that bear no relation to the name of the funds.¹⁰⁵ This is of concern because many investors choose a mutual fund based on its name.¹⁰⁶ Currently, only 65% of a mutual fund's assets must be invested in securities that are related to the name of the fund.¹⁰⁷ Even vigilant investors who read the fund prospectus will find a dearth of clear information about the emerging nation debt component of the portfolio.¹⁰⁸

6. Elements of Country Risk

Investors in the secondary market for Third World debt face another set of risks referred to collectively as "country risk." Country risk refers to situations in which the host country is unable to facilitate transfers of its currency.¹⁰⁹ Even a pur-

102. U.S. banks are taking advantage of a loophole in SEC regulations wherein they do not have to report investments in a single nation that are less than 0.75% of the bank's total assets. This reporting requirement excludes bank holdings of Brady bonds entirely. *Hidden Horrors*, THE ECONOMIST, Oct. 22, 1994, at 95.

103. Bary, *supra* note 9, at 8.

104. Gregory Zuckerman, *More Bond Mutual Funds Are Taking On Risks And Only The Most Wary Investors May Know It*, WALL ST. J., Sept. 17, 1997, at C1.

105. *Id.* at C25.

106. *Id.*

107. *Id.*

108. For example, the Strong Opportunity Fund prospectus includes the caveat that "the Fund may invest up to 5% of its net assets in non-investment grade debt obligations." STRONG FUNDS, THE STRONG GROWTH FUNDS PROSPECTUS I-13 (May 1997). Although the Strong Opportunity Fund's description says it "may invest up to 25%" of its assets in "foreign securities," it does not specify the types of securities — or which countries — in which the fund will invest. The unwary investor may not realize that "foreign" can just as easily mean Zaire as Belgium. Only if the investor then turns to another section, Implementation of Policies and Risks, will the investor read a brief and superficial account of possible foreign investment risks. *Id.* at I-17-24.

109. Harrell, *supra* note 79, at 902.

chaser of an investment not issued by the sovereign itself, but by a private entity, still bears the risk that not only will the issuer not honor the debt, but that an element of country risk outside the private borrower's control may prevent repayment.¹¹⁰

Some elements of country risk are beyond the control of the sovereign government. Contagion affects the credit rating of a nation. This results when the economic conditions of a geographically or economically similarly-situated nation have a spillover effect on the perceived creditworthiness of the host nation.¹¹¹

Country risk is so unpredictable that even sophisticated rating agencies are not always able to gauge it with accuracy.¹¹² Standard & Poor's, for example, gave a positive outlook for a future upgrade on Mexican debt shortly before the Mexican Peso Crisis of 1994.¹¹³ Part of the reason that even professional analysts have difficulty assessing country risk correctly is the difficulty in obtaining timely data from emerging nations about their economic fundamentals.¹¹⁴

110. Thomas C. Baxter, Jr., *Electronic "Checks" and "Purses": The New Payment Systems*, in THE EMERGED AND EMERGING NEW COMMERCIAL CODE, SB29 A.L.I.-A.B.A. 224, 248 (Dec. 12-14, 1996). Country risks inherent in international investments are:

- (i) deterioration in the value of the sovereign's currency in relation to the currency in which the issuer's debt is denominated (i.e. exchange rate risk);
- (ii) imposition of exchange controls or similar actions that could limit convertibility of the sovereign's currency (i.e. transfer risk);
- (iii) deterioration of general business and economic environment or detrimental regulatory actions;
- (iv) declaration of a moratorium or similar prohibition or restriction against any payments on external debt;
- (v) temporary diversion of debt service payments;
- (vi) expropriation of the issuer or its property and repudiation of its debt; and
- (vii) civil unrest, including social and labor disturbances.

Weseley, *supra* note 94, at 375.

111. James C. Allen, *OCC Moves to Lessen Risk Of Emerging Markets Fiascos*, AM. BANKER, Dec. 22, 1995, at 20 ("One of the things we've seen with respect to the situations with the peso is that the various emerging markets may not be as disconnected as previously thought. . . . [F]ollowing the collapse of the peso, we saw volatile movements in currencies and interest rates in Asia and other markets").

112. *Room for Improvement*, THE ECONOMIST, July 15, 1995, at 54 (suggesting that agencies have trouble gauging the risk because of their lack of experience and the inexact science of the practice).

113. *Id.*

114. Mexico, for instance, was "clearly less than forthcoming about [its] economic and financial situation" prior to the Peso Crisis of 1994. Truman, *supra* note 35, at 208. Full disclosure of economic factors will benefit the debtor nation because more investment will be attracted. Mexico now makes its fiscal information available on the Internet. Summers, *supra* note 53, at 46.

E. EFFECTS OF FOREIGN INVESTMENT ON THE DEBTOR NATION

Portfolio investment supplied 50% of all net external finance to Latin America between 1982 and 1992.¹¹⁵ Without immediate returns, portfolio investors will quickly move their capital elsewhere.¹¹⁶ This strategy of maximizing short-term gain makes portfolio investment a potentially destabilizing force to the developing nations in which they invest.¹¹⁷ With the advent of today's global financial marketplace and advances in telecommunications, any hint that the investment climate in a country is turning negative — whether true or false — can send that country's economy into a tailspin.¹¹⁸ The power of the portfolio investor is so strong that even large, industrialized nations, such as the United States, are not always able to resist their force.¹¹⁹

Another factor emerging nations should consider in relation to portfolio investment is what the portfolio investor will do in the event that the emerging nation needs to seek rescheduling.¹²⁰ During previous debt crises, the commercial bank creditors collectively met and negotiated new deals with the debtor nation.¹²¹ The IMF, World Bank, and Federal Reserve exerted pressure on these banks, forcing them to cooperate with debtors by threatening them with the possibility of new regulations.¹²² Such cooperation is bound to be lacking from an extremely large and diverse group of portfolio investors.¹²³

115. Carrasco & Thomas, *supra* note 8, at 542.

116. *Id.* at 543.

117. Local stock markets can be disrupted, interest rates can shift dramatically, and the local business climate can be damaged in the wake of sudden, large shifts in portfolio investments. Carrasco & Thomas, *supra* note 8, at 543. See generally David Wessel, *Closing the Door*, WALL ST. J., Sept. 18, 1997, at R21 (discussing the instability caused by quick withdrawals of capital and the questionable benefits of short-term capital for developing countries).

118. Edmunds, *supra* note 64, at 127-33. A small country that is dependent on foreign trade can be devastated by media speculation, even if its economic condition is sound, as foreign exchange exits and liquidity dries up on the basis of a rumor. *Id.* at 131.

119. Carrasco & Thomas, *supra* note 8, at 543 n.5.

120. Not an unrealistic concern, considering that the Paris Club negotiated more than 60 reschedulings from 1956 to 1983. *Debt Rescheduling: What Does It Mean?* FIN. & DEV., Sept. 1983, at 26, 28. See generally Humphrey, *supra* note 55, at 190-91 (describing difficulties of debt rescheduling negotiation when lenders are a large group of relatively small investors rather than a concentrated cadre of commercial creditors).

121. Carrasco & Thomas, *supra* note 8, at 593.

122. *Id.* at 594.

123. Holders of securitized emerging market debt are "the big gap in the international system for handling sovereign crises" because tens of thousands

There is also the potential that large institutional investors will take on a more assertive role.¹²⁴ This is exactly what has happened with a large pension portfolio managed for the California Public Employees Retirement System (CALPERS).¹²⁵ When IBM, General Motors, and American Express stocks were performing poorly, CALPERS demanded that the executives of those companies be replaced.¹²⁶ Certainly, no sovereign nation would want to tolerate such interference in its own internal affairs to retain large portfolio capital investments.¹²⁷ Developing nations should implement measures designed to lessen the potential negative impacts which the volatility and short-term investment strategies of portfolio investors create.¹²⁸

II. RETIREMENT FUNDING

A. RETIREMENT DEMOGRAPHICS

Congress enacted Social Security legislation as part of the New Deal in the 1930s.¹²⁹ The government never intended this federal program to be the sole, or even the primary, source of support for retired workers.¹³⁰ Benefits were intended to pay about 45% of a worker's earnings during one year of employment.¹³¹ Today's Social Security surplus will disappear by 2019.¹³² By the year 2030, there will be only two workers for

of individuals have replaced the bank syndicates. The sheer number of creditors makes it impossible for them to organize, as banks did in the 1980s, to reschedule debt. Summers, *supra* note 53, at 48.

124. Franco, *supra* note 30, at 494.

125. David L. Gregory, *The Problematic Status of Employee Compensation and Retiree Pension Security: Resisting The State, Reforming The Corporation*, 5 B.U. PUB. INT. L.J. 37, 40 (1995).

126. *Id.*

127. Something like this happened with the Mexican Peso Crisis of 1994 when the Weston Group, which specialized in Latin American investments for large investors such as Fidelity Investment, suggested six changes in fiscal policy that Mexico could make to attract and retain U.S. investors. Carrasco & Thomas, *supra* note 8, at 590.

128. Debtor nations can discourage excessive portfolio capital by direct measures such as taxes, limits on offshore borrowing, or limits on consumption credit. Carrasco & Thomas, *supra* note 8, at 597-98; Wessel, *supra* note 117, at R23.

129. Social Security Act (Old Age Pension Act) 42 U.S.C. § 301-1399 (1935). See also Patricia E. Dilly, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063, 1123 (1997).

130. Dilly, *supra* note 129 at 1120.

131. *Id.*

132. William G. Dauster, *Protecting Social Security and Medicare*, 33 HARV. J. ON LEGIS. 462, 480 (1996).

each retiree.¹³³ Indeed, many of those under 40 believe there will be no Social Security payout for them when they retire.¹³⁴

Average life expectancy has been increasing.¹³⁵ This means that, on average, the current generation is likely to have higher medical expenses than did the previous generations.¹³⁶ As a result of all these factors, there has been an increased emphasis on private saving for pensions, both by individuals and the corporations who employ them. For many Americans, their pension plan represents their largest financial asset.¹³⁷

Pension funds have become one of the largest collections of investment monies in the world. The collective assets of U.S. pension plans are \$3 trillion and constitute 40% of the capital in the United States.¹³⁸ The world's 300 largest pension funds grew by 14.3% in 1993 and by similar amounts in 1994 and 1995.¹³⁹

B. REGULATION OF PENSION FUNDS

It became obvious by the 1970s that corporate pension plans were not failproof. As a result of a CBS television exposé describing how corporate bankruptcies, specifically in the Horn & Hardart and Studebaker Worthington companies, had resulted in substantial losses for pension beneficiaries,¹⁴⁰ the U.S. government created both the Employee Retirement Income Security Act (ERISA) and the Pensions Benefit Guaranty Corporation (PBGC) in 1974.¹⁴¹

133. Kay Harvey, *As Youth Fades, Boomers Shape Next Life Stage*, ST. PAUL PIONEER PRESS, Oct. 12, 1997, at 12A.

134. Only slightly more than one third of Americans have confidence in the future of Social Security. Dauster, *supra* note 132, at 469-70.

135. W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 383 (1997).

136. *Id.*

137. *Id.* at 382.

138. Alvin D. Lurie, *ETIS: A Scheme For the Rescue of City and Country with Pension Funds*, 5 CORNELL J. L. & PUB. POL'Y 315, 333 (1996).

139. Edmunds, *supra* note 64, at 121.

140. Douglas A. Love, *ERISA: The Law Versus Economics*, 25 GA. L. REV. 135, 137 (1990).

141. Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001-1461. James B. Shein, *A Limit on Downsizing: Varity Corp. v. Howe*, 24 PEPP. L. REV. 1, 6-9 (1996).

1. ERISA

The principal aims of ERISA are to prevent the default of pension plans and prohibit self-dealing by pension fiduciaries.¹⁴² The two federal agencies charged with responsibility for the administration of ERISA are the Department of Labor (DOL) and the Treasury Department.¹⁴³ The DOL has jurisdiction over reporting and fiduciary obligations.¹⁴⁴ Government employee pension plans, defined contribution plans, church plans, and insurance contract plans are excluded from ERISA oversight.¹⁴⁵ Only defined benefit plans are subject to ERISA's minimum funding requirements.¹⁴⁶

Employers have relied on two main techniques to finance pension plans: trust funds and insurance contracts.¹⁴⁷ Fiduciaries "control and manage pension plans and their assets."¹⁴⁸ They must act with prudence, solely for the benefit of plan participants, and they must diversify to minimize risk.¹⁴⁹ ERISA preempts all state laws relating to pension plans.¹⁵⁰

2. Pension Benefit Guaranty Corporation

The PBGC is the insurer of last resort for the nation's 40,000 defined-benefit pension plans.¹⁵¹ Its protection is analogous to the FDIC's protection of consumer bank accounts.¹⁵² When the PBGC decides that an employer's pension plan is underfunded, the PBGC terminates the plan and pays minimum

142. Deborah M. Weiss & Marc A. Sgaraglino, *Prudent Risks for Anxious Workers*, 1996 WIS. L. REV. 1175, 1190 (1996).

143. Jacqueline Grossman, *Researching Hot Topic Practice Areas: Employee Benefits*, in MANAGING THE PRIVATE LAW LIBRARY 1989: DELIVERING INFORMATION SERVICES, 278 P.L.I./PATENTS, COPYRIGHTS, TRADEMARKS, & LITERARY PROP., 459, 462 (July 1989).

144. *Id.*

145. ERISA § 1321(b); 1081(a)(8).

146. Grossman, *supra* note 143, at 467.

147. *Id.*

148. *Id.*

149. *Id.*

150. Harold Novikoff & Seth Gardner, *Single-Employer and Multiemployer Pension Plan Liabilities in Bankruptcy Code Cases*, in CHAPTER 11 BUSINESS REORGANIZATIONS, SB37 A.L.I.-A.B.A. 369, 373 (May 8, 1997).

151. See also John F. Wasik, *How to Protect Your Pension*, CONSUMER DIG., Nov./Dec. 1996, at 35, 42 (stating that ERISA created the PBGC with the intention of making the agency "an insurer of last resort," and that the PBGC only guarantees a maximum of approximately \$2,600 per month per pensioner upon taking over a failed plan).

152. *Id.* at 35.

benefits to those who were covered by it.¹⁵³ More than 120 pension plans were terminated in 1995.¹⁵⁴ The PBGC has terminated the pension plans of such well-known names as Schwinn Bicycle, Pan Am, and Allis-Chalmers.¹⁵⁵

The PBGC suffered a deficit of \$2.9 billion in 1993.¹⁵⁶ A 1993 Congressional research report compared the potential harm of this problem to that caused by the savings and loan bail-out of the 1980s.¹⁵⁷ There has been concern about the long term solvency of the PBGC.¹⁵⁸ Even when the PBGC is fully funded, however, the employees it is supposed to rescue may get far less than they expected.¹⁵⁹

The PBGC is in better health now due to higher interest rates and the increased pension contributions mandated by the Retirement Protection Act mandates.¹⁶⁰ In 1996, the PBGC announced its first surplus.¹⁶¹

3. *The Retirement Protection Act of 1994*

The Retirement Protection Act of 1994 (RPA) was enacted as part of the legislation adopting the Uruguay Round of the GATT.¹⁶² The RPA recognizes that other GATT provisions will result in at least short-term reductions in federal revenues due to decreased tariffs.¹⁶³ By amending ERISA and the Internal Revenue Code, the RPA helps offset this decrease in revenue by

153. *Id.* at 39.

154. *Id.*

155. *Id.*

156. Leigh Allyson Wolfe, *Is Your Pension Safe? A Call for Reform of the Pension Benefit Guaranty Corporation and Protection of Pension Benefits*, 24 Sw. U. L. REV. 146, 153 (1994).

157. Wasik, *supra* note 151, at 42.

158. Maria O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well In An Inefficient Market, 42 AM. U. L. REV. 1, 23 (1992).

159. Some Pan Am employees found that the PBGC, which took over the bankrupt Pan Am pension fund, paid little more than half the monthly pension benefits they had been promised. Albert R. Karr, *Imperilled Promises: Risk to Retirees Rises As Firms Fail to Fund Pensions They Offer*, WALL ST. J. Feb. 4, 1993, at A1.

160. *Id.*

161. Glen Burkinn, *Pension Guarantee Agency Posts Surplus for First Time*, WALL ST. J., Apr. 1, 1997, at A4.

162. Retirement Protection Act of 1994, Pub. L. No. 103-465, § 108 Stat. 5012; Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, Legal Instruments—Results of the Uruguay Round (1994), 33 I.L.M. 9 (1994). See also Novikoff & Gardner, *supra* note 150, at 374.

163. Jeffrey R. Houle, *How GATT Changes American Pension Plans*, LEGAL TIMES, Jan. 16, 1995, at 20 (photo. reprint, Mar. 1995).

increasing other sources of revenue.¹⁶⁴ Specifically, the RPA will result in smaller lump-sum distributions from defined benefit plans by changing the interest rate formula.¹⁶⁵ It will also base cost of living increases for defined benefit plans on third, rather than fourth quarter inflation rates.¹⁶⁶ This will lower the amount of income that will qualify as tax-deferred.¹⁶⁷ Ordinarily, any reductions in participants' benefits such as these would be prohibited by ERISA.¹⁶⁸ As part of GATT, the RPA provisions will take precedence over ERISA.¹⁶⁹ A positive note for retirees is contained in two provisions of the RPA which strengthen the pension system—the RPA raises the funding minimums for defined benefit plans and increases premiums paid to the PBGC.¹⁷⁰

C. TRENDS IN FUNDING PENSIONS

1. *Movement from Defined Benefit to Defined Contribution*

Traditionally, pensions were "defined benefit" plans which promised employees a specific amount of payments after retirement.¹⁷¹ In a defined benefit plan, the employer bears the risk that contributions to the pension asset pool and decisions about their investment will result in sufficient funds to meet its long-term pension obligations.¹⁷² Under a defined contribution plan, however, employees are not guaranteed a specific pension by their employer when they retire.¹⁷³

Employers have created more defined contribution pension plans than defined benefit plans since ERISA was enacted.¹⁷⁴ Employers prefer defined contribution plans because they shift the risk of the pension investment decisions to the employee.¹⁷⁵ Employers also favor defined contribution plans because there

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.* at 21.

169. *Id.* at 20 ("GATT provides . . . that any plan amendments adopted to comply with the new rules will not be deemed prohibited cut backs").

170. *Id.* at 21.

171. Love, *supra* note 140, at 136.

172. *Id.*

173. *Id.*

174. There have been 150,000 more defined contribution plans than defined benefit plans created since the enactment of ERISA. 60A AM. JUR. 2D *Pensions and Retirement Funds* § 15 (1988).

175. 401(k)s *Bank on Markets*, REC. N. N. J. A14, JAN. 2, 1996 available in 1996 WL 6124902.

are no minimum funding requirements, no PBGC premiums, and no actuarial certifications.¹⁷⁶ Employees like them because they have the ability to choose their pension fund investments.¹⁷⁷ However, there is concern that the average worker will not have the expertise necessary to make good investment choices with his defined contribution pension plan.¹⁷⁸

2. *Managing Risk Through Diversification*

The fiduciary rules of ERISA regulate pension investments.¹⁷⁹ ERISA has its foundation in the common law of trusts,¹⁸⁰ which imposed two duties on the fiduciary: investments must be individually prudent, and the overall portfolio must be diversified.¹⁸¹ The first duty evolved into the "prudent man" rule.¹⁸² ERISA defines this as "the care, skills, prudence, and diligence . . . that a prudent man acting in a like capacity and familiar with such matters would use . . ."¹⁸³ Under this prudent man standard, certain types of investments were judged too imprudent for a trust corpus.¹⁸⁴ Examples include securities purchased for speculation and shares in new and untried enterprises.¹⁸⁵ Traditional trust law also required that the fiduciary diversify unless it was imprudent to do so.¹⁸⁶

The law of private trusts and ERISA fiduciary standards are no longer as congruent as they were when ERISA was enacted.¹⁸⁷ The fiduciary duty for a private trust is now incorporated in the Third Restatement of Trusts,¹⁸⁸ which utilizes the "prudent investor" standard for management of trust assets.¹⁸⁹

176. Howard J. Peyser & Gary Blank, *Design and Operation of 401(k) Plans*, in UNDERSTANDING ERISA 1995, 370 PLI/Tax 603, 608 (1995).

177. *Id.*

178. Independent economic variables such as increased inflation could leave retirees without as much spending capacity as they had anticipated. In that event, some predict that the retirees will petition the federal government for relief, and the federal government will force employers to transfer wealth from stockholders to employees. Love, *supra* note 140, at 141.

179. Weiss & Sgaraglino, *supra* note 142, at 1177.

180. *Id.* at 1184.

181. *Id.* at 1186.

182. *Id.* at 1185.

183. ERISA § 1104(a)(1)(B) (1994).

184. Weiss & Sgaraglino, *supra* note 142, at 1185.

185. *Id.* at 1185 n.22.

186. *Id.* at 1186.

187. *Id.* at 1196.

188. Restatement (Third) of Trusts § 227 (1990). See also Weiss & Sgaraglino, *supra* note 142, at 1196.

189. Phillips, *supra* note 135, at 345.

Under this new approach to trust investment, no specific security or category of security is outlawed because it is too inherently risky or speculative.¹⁹⁰ ERISA does not bar any individual investment as being too risky *per se*, either.¹⁹¹ To paraphrase Will Rogers, the "prudent investor" has never met an investment he didn't like. Junk bonds, international investments, vulture funds, and gold can now be pension fund assets.¹⁹² The old standard which prohibited investment in "new and untried enterprises" or "unseasoned entities," thereby keeping fund trustees from speculative investments such as junk bonds and leveraged buyouts, no longer provides a bright line between permissible and proscribed investments.¹⁹³

The guiding principle of portfolio theory is that "[t]wo assets properly combined may have less risk than either asset alone."¹⁹⁴ The trick to responsible portfolio management is identifying assets whose risks are negatively correlated with each other.¹⁹⁵ The traditional example of two negatively correlated assets offsetting each other's risk is the diversified portfolio with stock in companies that make umbrellas and sunglasses.¹⁹⁶ An optimally diversified portfolio, with negatively correlated risks, will eliminate "unique" risks that are company or industry specific.¹⁹⁷ Investors are not compensated for unique risks; therefore, it is not prudent to assemble a portfolio that does not diversify away such risks.¹⁹⁸

It is in the duty to diversify that the Restatement and ERISA have parted ways. Under the Second Restatement there were no exemptions to this duty to diversify.¹⁹⁹ The Third Restatement allows greater latitude in matters of diversification.²⁰⁰ ERISA case law has eliminated any fiduciary duty to diversify.²⁰¹ Under current ERISA standards, a fund can con-

190. *Id.* at 354.

191. 29 C.F.R. §2550.404a-1 (1996).

192. Arthur H. Kroll, *Nontraditional Investments Under ERISA: Panning for Gold*, 9 PROB. & PROP. 23-25 (1995).

193. Michael T. Johnson, *Speculating on the Efficacy of Speculation: An Analysis of the Prudent Person's Slipperiest Term of Art in Light of Modern Portfolio Theory*, 48 STAN. L. REV. 419, 431-33 (1996).

194. Weiss & Sgaraglino, *supra* note 142, at 1186.

195. *Id.*

196. *Id.* at 1188-89.

197. *Id.*

198. *Id.* at 1189.

199. *Id.* at 1190.

200. Phillips, *supra* note 135, at 356.

201. Weiss & Sgaraglino, *supra* note 142, at 1191.

sist of only one asset.²⁰² ERISA itself contains no guidelines for diversification.²⁰³ Further, the DOL believes that questions about diversification are issues of fact, not law, and refuses to issue opinion letters about pension fund diversification plans until after such plans have been created.²⁰⁴

Some aspects of fiduciary duty for pension funds have remained constant. The overarching imperative of pension fund management is that the pension fund must be managed so as to provide for the secure retirement of the worker.²⁰⁵ The fiduciary cannot delegate away his responsibility to oversee the investment of pension funds.²⁰⁶

Bisceglia v. Bisceglia illustrates the consequences that can occur when an unsophisticated investor, without specific guidelines from the DOL, invests too large a proportion of his pension assets in a high risk instrument.²⁰⁷ Joseph Bisceglia was a plumber who provided a pension plan for his employees. At the suggestion of his accountant, Bisceglia hired an investment advisor to manage the pension plan. At the investment advisor's suggestion, he invested 90% of the pension assets in real estate and 36% of the pension's total assets in one real estate partnership. Although this investment produced high returns for a few years, eventually the value plummeted, and Bisceglia saw the pension assets decrease by 90%. The court said the trust was undiversified, but did not hold the defendant liable. Bisceglia and his employees, unfortunately, lost nearly all their retirement savings because his pension fund was not adequately diversified.²⁰⁸

3. Pension Fund Holdings of International Investments

It is no secret that developing nations and those who already trade emerging nation debt are eyeing pension funds and hoping to increase their participation in the market. It has been a "perennial hope" of emerging market debt traders that pension

202. *Id.*; See *Reich v. King*, 867 F. Supp. 341, 344-45 (D. Md., 1994) (holding that a pension plan portfolio with 70% of its assets in mortgages in land from one county was acceptable).

203. *Weiss & Sgaraglino, supra* note 142, at 1192.

204. *Id.* at 1212.

205. *Lurie, supra* note 138, at 330.

206. *Reich v. Hosking*, 20 EBC 1090 (E.D. Mich. 1996) (holding that a pension plan trustee is personally liable for investment decisions made by a professional financial advisor who actively managed the plan, even if the trustee was passive).

207. *Bisceglia v. Bisceglia*, 17 F.3d 393 (9th Cir. 1994).

208. *Id.*

plans will make a significant switch in their investments from corporate bonds to emerging markets debt instruments.²⁰⁹ At least one firm is creating an emerging markets global debt fund specifically targeted to U.S. pension funds.²¹⁰ Indeed, more pension funds have been testing the emerging markets waters.²¹¹ In 1994, only fourteen pension funds reported holding at least 1% of their assets in Third World debt.²¹² In 1995 that number rose to nineteen; in 1996 it was twenty-four.²¹³ Although most of those limited their Third World debt exposure to only 1% of their assets, Guilford College had 21%, and United Way of Mercy (Chicago) had 33% invested in emerging nation debt.²¹⁴

Market watchers say they have detected a "subtle loosening" of investment guidelines, permitting portfolio managers to increase the amount of developing nation debt in pension funds.²¹⁵ Pension funds are buying the new asset-backed securitizations offered by emerging nations.²¹⁶ Pension funds that are already in the emerging nation debt market are beginning to look at branching out into local currency-denominated debt.²¹⁷ This will add currency risk to the other risks of these investments.

III. THE PROPOSAL: A REGULATORY FRAMEWORK TO SAFEGUARD PENSION FUND INVESTMENT IN EMERGING NATION DEBT INSTRUMENTS

A. THE NEED FOR FEDERAL LEGISLATION

An investment backed by the full faith and credit of a sovereign nation and with a rate of return twenty percent higher than U.S. Treasuries is bound to attract many professional pension fund managers, as well as individuals making decisions about IRAs or 401(k) plans. When the sovereign nation in question is a developing nation which has already defaulted on external

209. *Emerging Markets Beckon Pension Funds*, LDC DEBT REP., Sept. 23, 1996, available in 1996 WL 5559953.

210. *ANZ set to launch new fund products*, LDC DEBT REP., July 14, 1997, available in 1997 WL 13917679.

211. IBM employees, for example, hold Bulgarian Interest Arrears Bonds in their pension portfolio. 61 Fed. Reg. 47195, 47199, Dept. of Labor Pension and Welfare Benefits Administration (1996).

212. *Pension Plans Wade Deeper Into EM Debt*, LDC DEBT REP., June 2, 1997, available in 1997 WL 7939482.

213. *Id.*

214. *Id.*

215. *See supra* note 209.

216. Elstein, *supra* note 95.

217. Hinchberger, *supra* note 68, at 138.

debt obligations at least once in the last decade, the risk may be too great to permit its inclusion in a pension portfolio. Investors should apply the same caution to investments in corporations located within high risk nations.

Third World debt is often invisible to the people who own part of it. An investor who deliberately seeks out and purchases a Costa Rican Brady bond knows that he has purchased a piece of sovereign debt. If he so wishes, he can investigate the various risks attendant to such an investment. Emerging market debt funds are a transparent way to invest in sovereign debt. However, a less sophisticated investor who merely purchases shares in a mutual fund may unwittingly hold developing country debt.²¹⁸ A person could assemble a "diversified" pension portfolio holding an oil and gas securitization (including a healthy dose of country risk), stocks in banks (with underreported Third World loans), an uncollateralized Eurobond, a transparent securitization of Third World debt, and shares in a mutual fund with 20% of its assets in Third World debt. The cumulative effect of such investments would still yield a high risk portfolio. There is currently no mechanism to protect pension investors from such scenarios.

Some investment advisors believe that eclectic global debt funds offer the best counterbalance to a portfolio otherwise invested in U.S. stocks and Treasuries.²¹⁹ The argument is that a collection of Third World debt from a variety of issuers is weakly correlated with U.S. financial markets and, therefore, an ideal hedge against the vagaries of the U.S. economy and stock market.²²⁰

Between the investors who want to invest heavily in Third World debt in the hopes of high yields on their investments, and the investors who seek less risk but who nevertheless hold a large proportion of Third World debt, there is a tremendous likelihood that very soon many pension plans will have significant concentrations of Third World debt. Country risk, sovereign risk, the lack of transparency in some investments, the lack of

218. For example, an investor who in 1993 invested in Fidelity's "New Markets Income" mutual fund should expect to find 100% of the fund's assets invested in emerging market debt. The individual buying into Fidelity's "Asset Manager" fund or Dean Witter's "North American Government" mutual fund might well be surprised to learn that 20% of each of those funds was invested in emerging nation debt instruments. Bary, *supra* note 9, at 9.

219. Thomas Easton, *A Cosmopolitan Bond Portfolio*, FORBES, June 16, 1997, at 228.

220. *Id.*

investment guidance from the DOL,²²¹ the poor health of the Social Security program, and a pervasive expectation that the government will be the ultimate insurer of retirement funds make it incumbent upon Congress to enact safeguards for investment of pension funds in emerging nation debt.

Congress should enact legislation that recognizes the benefits of an orderly secondary market for highly indebted nations' debt and minimizes the risk that unsophisticated investors will purchase this debt with their pension assets and later engage in panic-induced selling. The volatility that exists in the absence of such legislation is detrimental to both investors and debtor nations. It would be impossible to mitigate the resulting effect of such a panic on the emerging nations' debt market — even those of nations with sterling credit histories. The industrialized nations cannot marshal the resources to bail out every global financial market crisis the way they did during the Mexican peso crisis of 1994.²²² Nor can government insurance schemes make good on all risky investment choices despite the present good health of the PBGC. Furthermore, there is no insurance safety net for the millions of workers whose pensions are not in the PBGC-insured defined benefit plans. Prophylactic action is needed now, before the risk curve associated with the supply of Third World debt intersects with the unprecedented demand of the retiring Baby Boomers for retirement income.

B. CONGRESS SHOULD ENACT LEGISLATION SIMILAR TO ILSA FOR THE PURPOSE OF REGULATING PENSION PLAN INVESTMENTS IN EMERGING NATION DEBT

Using ILSA as a model, Congress should enact an "Emerging Nation Debt Trading Supervision Act" (ENDTSA) that would begin with a Congressional declaration of policy that the United States wants to "assure the economic health and stabil-

221. The DOL will not issue pre-litigation opinions about the diversity of pension plan portfolios, and judicial indications are that concentration of assets in Third World debt may well be acceptable. Weiss & Sgaraglino, *supra* note 142, at 1178. While courts have not ruled on the advisability of Third World debt for pension funds specifically, they have held that concentration of 70% of a pension fund's assets in the real estate of just one county was acceptable. Reich v. King, 867 F. Supp. 341, 344-45 (D.Md. 1994).

222. A 1996 report issued by the G-10 nations (the 10 nations with the world's largest economies) "states clearly that nobody should expect large-scale bailouts in future." *No More Debt Crises Please*, ECONOMIST, May 18, 1996, at 74.

ity of the United States and the other nations of the world.²²³ It would mandate supervision to prevent imprudent and disruptive investment practices for all pension funds whether they are defined benefit, employer-sponsored defined contribution, or individually directed 401(k)s or IRAs. Although the goals of this proposal could eventually be achieved through administrative action, federal legislation would ensure uniform and timely compliance more rapidly.²²⁴ Such legislation should not be left to the states, because only the federal government has the resources necessary to assess all relevant foreign and domestic policy implications.²²⁵

When legislators drafted ILSA they did not try to completely curtail lending by U.S. banks to developing nations. Similarly, ENDTSA, as proposed in this Note, would not outlaw all investment in emerging market debt. Instead, ENDTSA would implement the three broad categories of reform the Federal Reserve recommended after the Mexican Peso Crisis of 1994: 1) increase transparency of the market for emerging nation debt instruments; 2) increase availability of data about economic variables from the debtor nations; and 3) create an early warning system for market participants.²²⁶

1. *The DOL Would Have Oversight of the Various Provisions of ENDTSA*

The DOL is already charged with oversight for ERISA; it would simplify administration of the new provisions added by ENDTSA if they were administered by an agency already involved in pension fund oversight. The DOL should be given the authority to issue sanctions similar to the capital directives which ILSA authorizes the FDIC to impose on banks that undertake imprudent international lending.²²⁷ Such directives have the force of an administrative final order and can be issued without a hearing.²²⁸ It is anticipated that the DOL, like the FDIC, would seldom be forced to use this power,²²⁹ but nevertheless it

223. This public policy declaration echoes the one found in ILSA. 12 U.S.C. §3901(a)(1)(1994).

224. Lurie, *supra* note 138, at 341.

225. *Argument for Exposure Ceiling*, *supra* note 35, at 445.

226. Truman, *supra* note 40, at 208-09.

227. John C. Deal, *Banking Law is Not for Sissies: Judicial Review of Capital Directives*, 12 J.L. & Com. 185, 186-87 (1993).

228. *Id.*

229. The FDIC only used this power four times in a nine-year period. *Id.* at 201.

should serve as a spur to ensure compliance. The legislation should include a statement to the effect that due to the volatility of the global financial market, it is of the utmost importance for the DOL to have the authority necessary to ensure rapid compliance with its prophylactic measures.

2. *Pre-litigation Guidance for Pension Fund Investments*

Under ENDTSA, the DOL would initiate a rulemaking project to provide pre-litigation guidance for pension fund investments. ERISA fails to set guidelines for the diversification of pension portfolios.²³⁰ Under the modern portfolio theory of investment, the entire portfolio must be analyzed to determine whether it is too risky.²³¹ Thus far, the DOL has made it a policy not to rule on whether a pension plan is adequately diversified on the theory that this is a question of fact and not of law.²³² Congress must direct the DOL to determine and then publish the factors it will consider in analyzing the risk of a portfolio and the percentage of pension assets that can be invested in a high risk category. The DOL should supplement these guidelines with pre-litigation guidance through regulatory opinion letters.²³³ This measure would help the small investor who does not utilize the expertise of a professional investment advisor.

3. *Increased Transparency*

The SEC, which already oversees mutual funds, should ensure that all mutual funds increase the transparency of their emerging nation investment strategy. This action would benefit the large number of pension fund investors who control their own pension funds and provide a basis for evaluation of diversification in larger defined benefit plans managed by employers.

(a) *Mutual Fund Transparency*

Each mutual fund registered in the United States should specify in a prospectus what percentage of its assets may be allocated to emerging nation debt. Currently, a fund prospectus can simply indicate what percentage of its assets will be invested "internationally." This is too broad a characterization to give a meaningful measure of the risk incurred. All mutual funds registered in the United States should comply with the SEC's re-

230. Weiss & Sgaraglino, *supra* note 142, at 1192.

231. Johnson, *supra* note 193, at 421.

232. Weiss & Sgaraglino, *supra* note 142, at 1212.

233. *Id.* at 1211.

quest that 80% of a mutual fund be invested in assets closely related to the fund's name. Today that requirement is only 65%.²³⁴ The name of the mutual fund plays a large role in an investor's decision to purchase it.²³⁵ A higher correlation between the name of a fund and its contents would make developing country debt more visible in a portfolio.

(b) Country Risk Prospectus

Under ENDTSA, a country risk prospectus should be sent to all 401(k) and IRA holders who invest in emerging nation debt. A "prospectus" specifically explaining emerging market debt instrument risks should be sent to an investor before he can place an order to purchase a stock or bond mutual fund that has some of its assets currently, or potentially, invested in Third World debt. Once an investor has purchased shares in such a fund, the investment company should send quarterly reports to the investor with updated specifics about the proportion and type of emerging nation debt held in the mutual fund portfolio. There is no way to ensure that the investor will read this material. Providing it, though, will put the investor on notice that he has incurred country risk.

4. Country Risk Rating System

The DOL should establish, in conjunction with the Inter-agency Country Exposure Review Committee (ICERC), a country risk rating system. The ICERC is composed of representatives from the Office of the Comptroller of the Currency, the FDIC, and the Federal Reserve.²³⁶ It already meets to establish reserve requirements based on country risk for banks making international loans.²³⁷ It assigns each nation a country risk category and requires additional capital reserves for bank loans to countries in three "problem" categories.²³⁸ The DOL should be able to obtain this information and use it to create an early warning system for pension funds investing in Third World debt. This early warning system of impending country risk would be similar to the GAO's recommendations for

234. Zuckerman, *supra* note 104, at C1.

235. *Id.*

236. *Argument for Exposure Ceiling*, *supra* note 35, at 438.

237. Ed Paisley, *U.S. to Release Credit Ratings for 15 Debtor Nations*, AM BANKER, Nov. 15, 1988, at 4.

238. *Id.*

commercial lenders.²³⁹ If necessary, the DOL could develop its own country risk analysis techniques.

In the event that the DOL believes a nation's political or economic risks make it too hazardous for pension funds, it should identify that nation to investors. ILSA contains a similar measure, requiring lenders to highly-indebted nations to set aside capital in Allocated Transfer Risk Reserves (ATRRs) to compensate for this additional risk to capital.²⁴⁰ Once the DOL has identified a nation as extremely high risk, it should publish information and require defined benefit plans to take protective measures.²⁴¹

5. *Cooperation with Foreign Agencies*

The DOL should seek to increase cooperative endeavors with foreign countries as ILSA aims to do. The United States already participates in a number of cooperative international bank supervisory groups.²⁴² The DOL should be able to work through these groups to increase the exchange of information about the financial statistics of governments and their agencies that float debt issues on the world capital markets.²⁴³

Currently, there are no regulations that require mutual fund managers to consider the interests of host countries.²⁴⁴ A formal recognition of the connection between U.S. economic self-interest and the interests of developing countries in the ENDTSA legislation would be a useful reminder to the financial markets of U.S. policy objectives.

6. *Aggregate Country Risk Exposure*

The DOL should analyze all large defined benefit pension plans based on an aggregated measure of country risk exposure in their portfolios. Bank regulators aggregate all loans to a foreign government, its agencies, and private international borrowers within its borders to determine the total level of exposure to

239. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO/NSIAD 88-87, INTERNATIONAL BANKING: SUPERVISION OF OVERSEAS LENDING IS INADEQUATE (1988).

240. Vander Schaaf, *supra* note 23, at 698-700.

241. See discussion *infra* part III.B.6.

242. Bench & Sable, *supra* note 28, at 429.

243. Full information about its economic variables will benefit the borrowing nation by attracting capital and promoting market discipline. Summers, *supra* note 53, at 47.

244. Carrasco & Thomas, *supra* note 8, at 591.

country risk.²⁴⁵ The DOL should consider whether the principle of aggregation should be applied to a group of countries, due to the risk of contagion in international investments.

(a) Additional Reporting Requirement

In order to assess the aggregate measure of country risk, the DOL should institute an additional reporting requirement. At present, a fund manager only has to tell the DOL the amount of assets invested in a category of assets, without specifically identifying the asset. For example, an Standard & Poor's index fund would count as "one" security, as would an investment in a single junk bond.²⁴⁶ A plan with all its assets in one index fund would be well-diversified, whereas a plan exclusively holding one class of Bulgarian bonds with the same maturity date would not be diversified. Yet, under current DOL reporting regulations, both would appear to be equal. The DOL needs more information if it is to monitor the proportion of the pension portfolio in emerging nation debt or maintain a list of plans for an early-warning system.

(b) Authority to Issue Directives

The DOL should have the authority to issue directives to defined benefit pension funds with too high a proportion of their assets in speculative emerging nation debt. The DOL should give the pension fund manager the option of selling the asset or setting aside a compensating balance in U.S. Treasuries. This measure would be similar to the ILSA measure requiring ATRRs for loans to highly indebted nations.

C. ALTERNATIVES

1. *Safe Harbor*

Less administrative oversight would be needed if the DOL simply mandated that small pension plans²⁴⁷ would meet all requirements for diversity and prudent investment if they followed the lead of large pension funds. Weiss and Sgaraglino

245. *Argument for Exposure Ceiling, supra* note 35, at 441. "Whether public or private, all borrowers within a country are subject to . . . the same economic conditions; a bank lending to many such borrowers is unlikely to achieve much risk diversification. Moreover, all borrowers within a country must draw on the same source of foreign exchange. . . ." *Id.*

246. Weiss & Sgaraglino, *supra* note 142, at 1212.

247. A small pension plan is defined as having fewer than 100 participants. *Id.* at 1205.

have proposed a "safe harbor" plan in a slightly different context.²⁴⁸ This suggestion would release pension plan fiduciaries from liability as long as they followed the same asset allocation guidelines of large investors.²⁴⁹ Such a plan can be successful only if the DOL has already implemented successful guidelines for the large pension plans to follow and if the decisions of the large investor plans are readily available to the small investment plans.²⁵⁰ It would also be necessary for the investment choices of the large plans to be replicated on a smaller scale by the small investor. This is not always possible, as some instruments require relatively high minimum investments.

2. *Eliminate Pension Investments in High Risk Countries*

A blanket prohibition against pension investments in high-risk countries would be easy to implement and the costs would be low. This prohibition would also eliminate any possibility that future developing nations' debt crises would hurt pension funds. Although this proposal would simplify the administrative task for the DOL, it would have too many negative repercussions for our economy and foreign relations.²⁵¹

D. RESPONSES TO POSSIBLE CRITICISMS OF THIS PROPOSAL

1. *It Would be too Difficult to Obtain and Analyze the Data Necessary for Meaningful Country Risk Decisions*

First, the federal government already has a country risk analysis system in place that the DOL can utilize. Second, if the DOL deems it appropriate, it can use secondary market prices as a basis for assigning country risk.²⁵² It costs nothing to access secondary market prices. Third, whenever the data is incomplete for a country risk analysis, the DOL can downgrade the country one risk level. This option should enhance compliance of developing nations in supplying this economic data on a timely basis.

248. *Id.*

249. *Id.*

250. This, however, would create a free rider problem. It is unlikely that the larger pension plans would be willing to make their investment decisions available at no cost.

251. Humphrey, *supra* note 55, at 215-16 (recognizing that international economic relations have the potential to cause a national security crisis).

252. The GAO recommended this method of country risk assessment. See *supra* note 237.

2. *Limiting Pension Investments in Emerging Nations Would Stem the Flow of Foreign Capital Needed to Bolster Economic Growth in Those Countries*

There is a possibility that some nations would see these new limits as punitive and take reciprocal action.²⁵³ It is also likely that developing nations will find alternative sources of financing, preferably from investors willing and able to make a long-term commitment. The DOL and SEC should strengthen the lines of communication with the financial leadership of these nations because rapid capital movements into and out of a developing country can have negative repercussions for its business climate and standard of living.²⁵⁴ The mechanisms in the proposed ENDTSA would decrease the flow of capital in a very few instances and should result overall in a more orderly flow of capital.

3. *Comprehensive Regulation of Pension Fund Investments in Foreign Debt is not Feasible*

Regulators may not always be able to keep pace with innovative financing techniques in the market for derivatives.²⁵⁵ Although this argument may apply to financial markets in general, it does not apply to pension funds. If a time lag exists between the creation of a new derivative instrument and the DOL's risk evaluation of it, there is no harm done to the pension plan beneficiary or the emerging nation that issued the underlying security.

IV. CONCLUSION

*A Third World debt bond should not be the conduit by which the banks unload past mistakes on an unwary public.*²⁵⁶

The proposed ENDTSA legislation would benefit emerging nations because it would help ensure an orderly flow of U.S. capital from pension plans for the continuation of trade financing and economic development programs.²⁵⁷ It is hoped that such legislation would dampen speculation sufficiently to prevent

253. *Argument for Exposure Ceiling, supra* note 35, at 447.

254. North, *supra* note 53, at 48.

255. Raj Bhala, *Equilibrium Theory, the FICAS Model, and International Banking Law*, 38 HARV. INT'L L.J. 1, 55 (1997) (arguing that banking regulators cannot keep pace with the abuses in derivatives).

256. Puchala, *supra* note 83, at 168.

257. See Franco, *supra* note 30, at 516-17.

panic selling at the first sign of a diminution of yields. It is recognized that the U.S. national economy is included in the concept of national security.²⁵⁸ Therefore, this proposal should be considered beneficial to the nation as a whole, as well as to the comfortable retirement of its senior citizens.

Emerging nation debt has been, and will continue to be, vitally important to the global economy in general and the economy of the United States in particular. The advent of the secondary market and the proliferation of securitized instruments has diffused the risk inherent in these investments somewhat, but this risk has not been eliminated. It would be imprudent, inconsistent with present law, antithetical to our national self-interest, and disastrous to the international economy to ban these investments from pension plans outright. Carefully crafted legislation, such as proposed herein, would help ensure the economic stability of developing nations, while improving the safety of U.S. pension assets, reporting standards, instrument transparency, and regulation of the secondary market.

258. Humphrey, *supra* note 55, at 181.