

CUSTODIAL BANKS: AVOIDING RISKS IN YOUR MOST TRUSTED RELATIONSHIP

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Agenda

- Introduction
- Presentation
 - G. Anthony Gelderman, Bernstein Litowitz Berger & Grossmann LLP
- Questions and Answers — (*anonymous*)
- Slides — now available on front page of Securities Docket
 - > www.securitiesdocket.com
- Wrap-up



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Panel



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Custodial Banks:

Avoiding Risks in Your Most Trusted Relationship

June 8th, 2010

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Agenda

- **The Custodial Relationship**
- **Securities Lending**
- **Foreign Currency Transactions**
- **Claims Administration**

The Custodial Relationship

- ❖ **Custodial banks provide numerous services that are essential to the operation of any public pension fund.**
- ❖ **Despite the turmoil in the financial markets, the core relationship between custodial banks and public pension funds remains sound.**
- ❖ **No indications of any custodial banks violating their fiduciary duties with regard to the central functions they perform.**

The Custodial Relationship

- ❖ The core services traditionally provided by custodial banks have expanded over time, and banks now provide their custodial clients with a host of ancillary services.
- ❖ Ancillary services provided by custodial banks, such as claims administration, have helped pension funds navigate the flood of litigation emanating from the financial crisis.
- ❖ Other ancillary services, however, create potential for risk, which can be managed if proper scrutiny is applied.

The Custodial Relationship

- ❖ **Pension fund trustees and executives must scrutinize the full array of services offered and provided by custodial banks.**
 - The services provided must be assessed based upon the nature of the service, rather than according to the identity of the service provider.
 - Treating all services provided by custodial banks as administrative functions, simply because the banks' primary functions are administrative, ignores the potential risks that may exist when a custodian is acting as an investment advisor or otherwise exercising discretion over the assets of the fund.

The Custodial Relationship

- ❖ **Several ancillary services provided by custodial banks provide real benefits, but require significant scrutiny:**
 - Securities Lending
 - Foreign Currency Transactions
 - Claims Administration

Securities Lending

- ❖ **Custodial banks commonly provide securities lending services to custodial clients.**
- ❖ **Many investors, such as hedge funds, borrow securities in order to engage in short selling and for other purposes.**
- ❖ **Pension funds that invest in commingled investment funds offered by their custodial bank, including index funds, may also participate indirectly in securities lending if those commingled funds participate in securities lending.**

Securities Lending

- ❖ When an investor lends securities, cash collateral received from the borrower is invested by the custodial bank in commingled investment pools. The custodial bank, or its investment advisory subsidiary, manages those investment pools.
- ❖ In a securities lending program, the custodial bank is acting as an investment advisor to the pension fund by managing the investment of cash collateral and may be managing assets with significant value.
- ❖ Securities lending services provided by custodial banks add value, which helps fund trustees and executives meet their fiduciary obligation of maximizing the return on the fund's assets.
- ❖ The risks involved in securities lending, however, must be recognized and managed appropriately.

Securities Lending

- ❖ **Securities lending cash collateral must be returned to the borrowers in the lending transaction when they return the securities.**
- ❖ **Accordingly, cash collateral must be conservatively invested in liquid, short-term securities. Pursuant to that guiding principle, pension funds have the right to dictate the specific guidelines that will govern the investment of their cash collateral.**
- ❖ **Securities lending, and the return on the investment of collateral, is only intended to generate limited returns due to the necessarily conservative nature of the investment.**
- ❖ **Securities lending was marketed to pension funds as a highly conservative investment that would generate consistent returns from cash that did not belong to the pension fund.**

Securities Lending

- ❖ **In the wake of the subprime mortgage collapse and credit crisis, several securities lending programs incurred realized and unrealized losses in their cash collateral investments pools.**

- ❖ **Several custodial banks were subsequently accused of imprudently investing securities lending cash collateral, seeking to generate higher returns beyond the objective of the securities lending programs:**
 - Investments in long-term securities
 - Investments in mortgage-backed securities
 - Investments in exotic instruments such as structured investment vehicles and collateralized debt obligations

Securities Lending

- ❖ **In addition, some custodial banks stand accused of improperly managing cash collateral investments as a result of conflicts of interest:**
 - Incentive compensation led banks to increase the risk in the cash collateral pools in order to generate higher returns.
 - Banks had financial relationships with issuers whose securities were held in the cash collateral pools, including structured investment vehicles.
 - Certain internal accounting concerns may have impacted the manner in which banks managed the collateral pools.

Securities Lending

- ❖ As a result of the allegedly imprudent investment of cash collateral, certain pension funds were surprised to learn of significant losses in securities lending programs that, historically, had yielded very low returns and which were understood to present very low risk.
 - Some banks responded by arguing that the losses resulted from the mortgage meltdown and ensuing financial crisis, and not from mismanagement.
- ❖ In September 2008, several custodial banks limited withdrawals from securities lending programs.
- ❖ These withdrawal limitations effectively locked in clients, many of which were harmed by further losses incurred in cash collateral pools in 2009, and are at risk of further losses because they cannot exit the lending programs.

Securities Lending

- ❖ There are now numerous class and individual litigations against custodial banks arising out of the alleged mismanagement of securities lending cash collateral pools.
- ❖ In some cases, the custodial banks may assert that pension fund trustees and executives are themselves responsible for the losses their funds incurred from securities lending, arguing that:
 - ❖ The pension funds elected to participate in securities lending, and assumed the risk of losing money through the investment of cash collateral; and
 - ❖ Pension fund trustees and executives should have closely tracked the investment of cash collateral and identified the risks undertaken in the cash collateral investment pools.

Securities Lending

- ❖ These cases turn on the facts specific to each securities lending program.
 - ❖ Claims against State Street were dismissed, after the unrealized losses in the cash collateral pools rebounded. State Street lending program incurred no realized losses in its cash collateral pools.
 - ❖ Jury verdict against Wells Fargo on behalf of securities lending participants.
 - ❖ Northern Trust settled certain individual actions, while class claims remain pending.
- ❖ In some cases, the custodial banks may assert that pension fund trustees and executives are themselves responsible for the losses their funds incurred from securities lending, arguing that:
 - ❖ The pension funds elected to participate in securities lending, and assumed the risk of losing money through the investment of cash collateral; and
 - ❖ Pension fund trustees and executives should have closely tracked the investment of cash collateral and identified the risks undertaken in the cash collateral investment pools.

Securities Lending

“As many as 90% of U.S. pension funds and many defined contribution plans have been badly sideswiped by valuation problems in the enhanced cash collateral pools that back securities lending activities.”

-- Pension & Investments

“Only a few institutional investors - less than 10% - got out of this alive because they got out early or were very conservative in their fixed-income investment management. They are the exception, not the norm.”

*-- Cynthia Steer, Managing Director
Rogerscasey, Inc.*

Securities Lending

In light of these developments, pension funds should consider a custodial bank that is managing assets as an investment advisor and scrutinize it based upon compliance with general investment objectives (conservative, liquid, short-term investments) and specific investment guidelines, and not merely as an administrator.

Securities Lending

- ❖ Pension fund fiduciaries do not need to micromanage the investment activity in securities lending programs, and were not required to review the specific investment decisions being made with regard to cash collateral.
- ❖ But, in light of the recent allegations that custodial banks mismanaged investments, fund fiduciaries should ensure that anyone who has discretion to invest the assets of the pension fund is subject to periodic review by staff or external consultants to ensure compliance with guidelines and objectives.
- ❖ Certain pension funds, relying on assurances about the low risk profile of securities lending programs, may not have subjected custodial banks managing assets in cash collateral pools to the same scrutiny that an investment advisor managing a comparable fixed income portfolio would receive.

Securities Lending

Reasonable precautions can prevent harm to the fund:

- ❖ **Establish specific guidelines to limit the investment of cash collateral to conservative, liquid and short-term investments. It is the right of the pension fund to dictate how cash collateral will be invested.**
- ❖ **Require periodic reviews of the securities lending program to ensure compliance with general objectives and specific guidelines.**

Securities Lending

- ❖ **Because the relationship with custodial banks is so extensive and generally long term, some pension funds may not have anticipated the need to terminate specific services provided by their custodial banks, and did not negotiate an absolute right to cease participation in securities lending programs.**
- ❖ **The withdrawal limitations imposed by many custodial banks effectively locked participants into these programs, causing some pension funds to incur additional losses.**
- ❖ **Pension fund fiduciaries can protect their funds by ensuring that, in securities lending as in other investment relationships, the fund has the ability to terminate the investment program at its discretion.**

Foreign Exchange Transactions

- ❖ Foreign Exchange (FX) transactions occur when a pension fund's investment advisor trades a security on behalf of the fund on a foreign stock exchange.
- ❖ To complete FX transactions, the pension fund must convert dollars from a U.S. account into foreign currency when purchasing a security on a foreign exchange, and must convert foreign currency back into U.S. dollars when selling a security on a foreign exchange.

Foreign Exchange Transactions

- ❖ **Custodial banks offer to execute the currency conversions necessary to complete FX transactions.**
- ❖ **In so doing, custodians are bound—as fiduciaries to their pension fund clients—to act in the interests of their clients and obtain the best currency exchange rate available at the time of the FX transaction.**
- ❖ **Custodial banks can add value in FX transactions by negotiating currency exchange rates for the benefit of their clients.**
- ❖ **Many pension funds utilize FX services provided by their custodial banks, while others rely upon independent vendors or investment advisers for FX services.**

Foreign Exchange Transactions

- ❖ In October 2009, the California Attorney General—acting on the basis of whistleblower allegations—accused State Street of overcharging pension funds on FX transactions.
- ❖ The Attorney General alleged that State Street ignored the exchange rates it was required to charge and either increased or decreased the exchange rate to favor State Street, causing millions of dollars of harm to the bank’s pension fund clients.
- ❖ Similar allegations have been made against other custodial banks in whistleblower complaints that remain under seal.

Foreign Exchange Transactions

"State Street bankers committed unconscionable fraud by misappropriating millions of dollars that rightfully belonged to California's public pension funds. This is just the latest example of how clever financial traders violate laws and rip off the public trust."

***-- California Attorney General
Jerry Brown***

Currency trading has been, on average, the richest source of trading revenue for U. S. banks over the past 12 years, accounting for \$2.1 billion of the \$5.2 billion total trading revenue in the second quarter of 2009, and \$11.4 billion in revenue for all of 2008, when total trading revenue was -\$836 million.

-- U.S. Government Data

Foreign Exchange Transactions

In light of the recent allegations by the California Attorney General, pension funds must scrutinize a custodial bank that is executing millions of dollars in currency transactions based upon compliance with contractual and fiduciary duties, and not merely as an administrator.

Foreign Exchange Transactions

Reasonable precautions can prevent harm to the fund:

- ❖ **Dictate contractual provisions to ensure that the contract specifically requires that the currency for FX transactions be exchanged at the best available rates at the time of the transaction.**
- ❖ **Periodic audits of FX transactions can determine whether currency is being converted at appropriate exchange rates.**
- ❖ **Third party vendors provide currency exchange negotiation services, and may also be able to assist with audits of FX transactions.**

Foreign Exchange Transactions

“The huge windfall custodial banks reap from foreign exchange trading is one of the industry’s worst kept secrets, and the potential cost savings for pension funds from greater due diligence in that area are great.”

*-- Cynthia Steer, Managing Director
Rogerscasey, Inc.*

Claims Administration

- ❖ **Custodial banks are well positioned to provide claims administration services.**
- ❖ **With full access to the portfolios of their pension fund clients, custodial banks can:**
 - **Track class actions**
 - **Identify settlements in which the fund has an interest**
 - **Complete claims forms**
 - **Provide supporting documentation**
 - **Manage claims submissions**

Claims Administration

- ❖ **Claims administration services are an area where custodial banks can add significant value by ensuring that pension funds do not forego opportunities and leave money on the table.**
- ❖ **By properly executing claims, custodial banks assist pension fund trustees and executives in the performance of their fiduciary obligations.**

Claims Administration

- ❖ But, because the interests created by securities litigation settlements are assets of the fund that may amount to millions of dollars, oversight of the claims administration process is necessary to ensure that fund assets are maximized.

*“During the period from 2006 to 2008, more than **\$35 billion** in securities class actions and regulatory settlements were finalized. But, according to a series of academic studies conducted over the last decade, as well as anecdotal evidence from market participants, anywhere from 30% - 70% of investors that are eligible to participate in a given settlement fail to file a claim form and thus leave the money on the table, to be recouped by other investors.”*

-- RiskMetrics

Claims Administration

Periodic audits can determine whether the bank is properly performing claims administration services.

Law firms, such as those providing portfolio monitoring services, and other vendors can provide periodic audits of the claims administration service.



Tony Gelderman

Mr. Gelderman heads the firm's Louisiana office and is responsible for institutional investor and client outreach. He is a frequent speaker at U.S. and European investor conferences, has written numerous articles on securities litigation and asset recovery, and is a recognized expert on fiduciary duty.

Earlier in his career, Mr. Gelderman served as Chief of Staff and General Counsel to the Treasurer of the State of Louisiana, and prior to that served as General Counsel to the Department of the Treasury. During his time with the Treasury, he coordinated all legislative matters for the State Treasurer. In addition, Mr. Gelderman helped to found the Louisiana Asset Management Pool and served for many years as the Pool's Secretary-Treasurer. He began his legal career as a law clerk to U.S. District Judge Charles Schwartz, Jr., Eastern District of Louisiana.

A former adjunct professor of law at the Tulane Law School, in 1995 Mr. Gelderman was profiled by the American Bar Association in Barrister magazine as one of the 25 young lawyers in America making a difference in the legal profession.

Questions?

Thank You

Thank you for attending this webcast.