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Judge Boots Sec Lending Case Against State Street

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A federal judge last week dismissed a lawsuit against **State Street** over its alleged mismanagement of a securities lending program, saying the Louisiana law firm that brought the claims had not suffered any actual injury.

The New Orleans-based law firm, **Fishman Haygood Phelps Walmsley Willis & Swanson**, said State Street breached its fiduciary duties of prudence and loyalty under the Employee Retirement Income Security Act by running a securities lending program as part of its administration of a collective trust in which the law firm's defined contribution plan invested.

In particular, plaintiffs claimed State Street invested cash collateral from the securities lending program in mortgage-backed securities and other instruments "with unusually high risk and unusually long duration." A lending agreement signed by both parties stated that the Boston-based money manager would instead invest the collateral in short-term instruments, such as money market funds, according to the recent court decision.

U.S. district court judge for the District of Massachusetts Patti Saris ruled last Thursday that the plaintiffs did not establish that they had suffered injury due to State Street's actions. Therefore, the law firm did not have standing to bring the case, Saris wrote.

"This is first-year law-school stuff, in a sense," says Gary Howell, partner at **Katten Muchin Rosenman**, and an expert on Erisa matters. To have standing, the would-be plaintiffs had to show an injury-in-fact, that the defendant caused it and that there's a remedy available, he says.

With securities lending, a fund loans out its securities in return for collateral that usually slightly exceeds the value of the securities. The collateral, which in the U.S. is usually cash, is then invested and the returns are generally divided between the lender and the lending agent.

Securities lending was seen as a relatively safe way to boost returns before the credit crisis, but during the meltdown collateral investments sometimes sank or became illiquid, and some funds experienced losses rather than the gains they expected.

Northern Trust, **Wachovia** and **BNY Mellon** have also faced lawsuits from 401(k) plans over their securities lending programs and losses they sustained during the credit crisis.

Custodian banks have seen significant decreases in their revenues from securities lending as a result of the credit crisis. Many mutual funds have also reviewed their lending agreements and revised them to lessen potential risks.

According to the recent decision, State Street's securities lending collateral pools lost value during the credit crisis and had an average net asset value of about $0.93 per unit. However, the $0.93 per unit reflected the market value and not the amortized cost value of $1 at which investors were generally able to transact, the decision says.

State Street did not impose any restrictions on withdrawals from the collateral pools but did state that the withdrawal of an entire collective trust, such as the American Bar Association Trust, in which Fishman participates, would result in "a pro-rata in-kind distribution of securities from the cash collateral funds to the extent its securities are on loan at the time of such a withdrawal," according to the decision.

Consequently, State Street said, if the mark-to-market value of the securities in the collateral pool was less than the amortized cost value of $1 per unit, the distribution of securities could have resulted in a loss to investors.

Due to the decrease in value of the collateral pools, Fishman sustained a net realized loss of $112, according to the plaintiff's expert witness, and $23,564 in net unrealized losses as of December 2008.

Defendants responded by noting that the net asset value of the collateral pools increased from $0.93 in December 2008 to $0.99 in January 2010. An expert witness for the defendants said that due to this increase, the plaintiff's unrealized losses of $5,537 as of Jan. 31, 2010 were about $3,000 less than the $8,587 in income from the securities lending program over that period of time.

The defendants' expert witness also compared the investment performance of the collateral pools with hypothetical investments in money market funds and short-term Treasurys — the securities in which the plaintiffs say State Street should have invested were it being more prudent.

"Mackay [the expert witness] provided a graph showing that the allegedly imprudent investments made by State Street outperformed hypothetical investments in 'short-term Treasuries' and money market funds at all times between January 1, 2007 to January 31, 2010, and most importantly in April 2009 when the complaint was filed," the decision says.

If one were to compare the total outstanding units in the collateral pool, valued at a dollar each, against the value of the underlying securities in the pool, the pool would not have had sufficient assets to redeem all of the outstanding units, says Marcia Wagner, founder of the **Wagner Law Group**, which mostly represents plan sponsors.

"However," she says, "since there was no mass withdrawal, the pool had enough liquidity to continue redeeming units at $1 to plan investors and also recover much of its losses over time."

Through a spokeswoman, State Street declined to comment.

An attorney for the plaintiffs did not respond to a request for comment.

Katten's Howell says he would be somewhat surprised if the plaintiffs appeal the case, given the thorough nature of the judge's decision.

The case, says Wagner, "highlights the fundamental importance of understanding all aspects of a plan's investment program, including something as mundane as its securities lending practices."