What's at Stake When Public Pensions Take on the Big Banks

A long-running lawsuit alleging collusion in the securities lending industry may be heading for class-action status. That could be a big deal not only for pension funds nationwide but also for the future of a $2.5 trillion marketplace.

OPINION: Girard Miller

GOVERNING

August 2, 2022

In a unique case alleging collusion in the securities lending industry, a federal judge in Manhattan recently opened the door for public pension funds from Iowa and California to file to certify as a class action their antitrust lawsuit against some of Wall Street's biggest investment banks. The case goes directly to the heart of an important, obscure and sometimes controversial niche in the institutional investment business: the lending of portfolio securities to third parties such as short sellers who pay a fee to borrow the stocks. Globally, this is a $2.5 trillion marketplace with fees industrywide measured in the hundreds of millions, so the stakes are very high.

Although the case, Iowa Public Employees' Retirement System v. Merrill Lynch, Pierce, Fenner & Smith Inc. et al., cites practices from a decade ago, its outcome — if plaintiffs prevail — could include treble damages recovery of claimants' alleged lost income from their past lending activities, fines on the banks and perhaps a more competitive marketplace.

Without getting too deeply into the weeds, this case is notable on several fronts. First, it's a lawsuit that as a class action could eventually gain a following by hundreds of public pension funds: California's largest county pension plan has joined with Iowa's and two of its sibling plans in leading the suit. Second, it's an antitrust case about pension operations and revenues, unlike most investment impairment class actions where pension funds are solicited to become a lead plaintiff by an ambulance-chasing law firm looking to extract a gold mine of legal fees from bedeviling a company that's got itself into trouble for reasons unrelated to pensions but that unluckily happens to be one holding of many in the fund's diversified investment portfolio. And third, one defendant's multimillion-dollar out-of-court settlement has already been reported.

Originally filed in 2017, the case had meandered through the courts for almost five years before the judge's ruling this June 30 recommending class-action status. That raises the ante for all parties involved, and makes this lawsuit appear to be more than just a bottom-fishing expedition by tort lawyers representing a few opportunistic clients looking to settle out of court for a quick payoff. And this case could pique the interest of federal regulators outside of the courtroom if the plaintiffs produce compelling evidence to support the lawsuit's allegations.

As with most lawsuits, there are two sides to this story. The companies deny the plaintiffs' claims, and there are supporters of their positions in the industry and on social media. That said, it should also be noted that Credit Suisse agreed to pay $81 million to settle the claims against it, without admitting any wrongdoing, which could mean that there are now three sides to this story. In any event, it's wise to avoid jumping to any conclusions until there are more facts laid out for public consumption, and innocence should be presumed unless proven otherwise.

One question that news reports about the current case have not yet addressed is what role was played by the pension funds' custodian banks, which hold the portfolio securities and through which the securities lending fees must pass. Were they just neutral bystanders in this process? Somebody might ask how much the defendant banks have spent on entertaining managers of the fund custodians. It's also not clear whether any of the investment banks' brokerage practices have changed for the better in the past decade; if they have, that likely would be the "stale bread" counter-argument at any trial.

Of course at this point it's impossible to predict how the case might unfold. A standard practice in class-action lawsuits is that potentially interested claimants are notified of their possible involvement and are given an opportunity to formally join in the action, litigate separately, or do nothing and ride along with the pack in hopes of a windfall. So pension officials should not be surprised to learn from their legal team that such notice has been received and hear the staff's recommendation as to the most appropriate action, if any, that their system should take.

For now, any pension official or staffer who has direct knowledge of pertinent facts that relate to this case should make that known immediately to their system's chief legal counsel. For many systems, their trustees' independent legal adviser and their investment consultant may have some background information on this matter that would be of educational value to the board and the staff.

No matter the outcome of this lawsuit, the issues it has raised make this a good time for trustees and staffs of pensions that engage in securities lending programs to take a good hard look at those programs. For decades, the practice of loaning out portfolio securities, mostly stocks, to third parties has been prudently exercised by public funds. The pensions are part of a larger marketplace: Mutual funds for individual investors and giant commingled funds for institutional investors, notably the low-fee index funds, also are frequent lenders of their larger portfolio holdings. The "rent" they earn from securities lending goes a long way in cutting their portfolio expense ratios by offsetting their management fees.

The downside of "sec lending," as it's known, is the counterparty risk that the borrower will default on its obligation to return the securities. This has been the bugaboo of worrywarts in the pension world for decades and it cannot be dismissed — although prudent over-collateralization, ongoing counterparty credit reviews and active securities oversight by the custodian are typically sufficient to allow trustees to sleep at night. A triennial or quadrennial review of all these protections is just good business practice for public funds. Pension fund risk managers, internal auditors and investment committees should routinely include this exercise in their standard multiyear schedule of due diligence reviews.

Perhaps the most enduring benefit from this litigation could be the advancement of a more-efficient, lower-cost electronic platform through which sec lending can be facilitated while still providing all the protections mentioned above. That’s reportedly one of the key aspirations in this lawsuit, and if the plaintiffs’ complaints are upheld or a settlement is negotiated, it seems likely that the ball would then fall into the pension funds’ court to actively promote an institutional marketplace that benefits parties on both sides of these transactions.

For now, though, that is just one of several possible outcomes, but the pension community would be wise to start putting this topic on their conference circuits so that trustees and staff members understand the implications and potential benefits of a new way of doing business that promotes efficient competition in the private sector.

Governing's opinion columns reflect the views of their authors and not necessarily those of Governing's editors or management. Nothing herein should be considered legal or investment advice.

Back to top