How to Resolve the Historical Data Conundrum and Recover More in Securities Litigation

Authored by

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Data is both omnipresent and ephemeral. Access to data, especially historical data, is a condition precedent to the ability file claims in settled securities class actions. Institutions have a fiduciary duty to file those claims, or to show that choosing not to do so was prudent. If an institution does not take a proactive approach to securing their data, significant problems can manifest downstream.

1. Determining Eligibility

In order to file and perfect a claim in most securities class action settlements, an institution will first need to determine whether they are eligible to participate in the litigation. This typically involves comparing the definition of the class (the group of investors that are to be included in a given litigation) to the current, or more commonly, the historical securities transactions of that institution. The class definition will typically spell out both which securities are included in the litigation as well as the period during which an investor had to purchase or sell the securities at issue, commonly called the "class period." On the surface this sounds straightforward; the reality is far more complex.

2. Ten Years, Really?

As an initial matter, the class period for a federal securities fraud class action can span a period of five years. Layered on top of that is the length of time that most cases take to reach the settlement stage -- 2-5 years -- and one can immediately sense that the data needed to file claims in settled cases can, and often is, quite historical.

This presents a real problem for institutional investors, as obtaining access to, searching through, and extracting 10+ year old securities transaction data is often not something that was planned for when custodial bank or prime brokerage relationships were initiated or terminated, or when internal fund management and accounting systems were built or sunset. As noted by recent surveys by publications such as Global Custodian, The TRADE and Global Investor, nearly 70% of asset managers use two or more custodian banks, and an overwhelming percentage of hedge funds have split their business among multiple prime brokers, with many having started new prime brokerage relationships during the past 18 months.

3. Failing to Look to the Future

Layered on top of service provider turnover, is the apparent failure to look to the future, when starting these new relationships. Indeed, an analysis of more than 100 RFPs issued during the last 5 years for custodial bank or prime brokerage services revealed that less than 10% of the RFPs even mentioned securities class action claims filing, and an even smaller percentage mentioned access to historical information if, and when, a custodial relationship is terminated. We have often encountered a reluctance on the part of a former custodian to grant a client access to their historical securities transaction information. This reluctance is often accompanied by a request for a fairly significant payment. Both issues might be avoidable, as discussed below.

4. Increasing Breadth = Increasing Complexity

Just as importantly, the breadth of class action settlements continues to expand. Whereas 20-25 years ago it was fairly common for a securities class action settlement to include just one security identifier (CUSIP, SEDOL, or ISIN). The cheap and ready access to the debt markets that remains commonplace has meant that an increasing number of companies issued debt securities or multiple tranches of preferred shares. These debt securities are increasingly being included in securities class actions and the resulting settlements. A quick analysis of settled cases finds that the percentage of settlements involving fixed income securities has dramatically increased over the years and now encompasses nearly 25% of all settlements in a given year.

5. Regulatory and Client Scrutiny is on the Rise

The need for this data is becoming more important as regulators and beneficiaries are turning a keener eye on the size of securities litigation settlements and the failure of investors to file claims in settled cases. Nearly two decades ago, a pair of prominent academics published the first of several seminal papers on the responsibilities and practices of institutional investors with regard to filing claims in settled securities class action cases. Their startling findings - that the vast majority of institutions lacked any formal process for tracking and claiming settlements - continue to reverberate through the industry to this day. Following on the heels of that groundbreaking study, the SEC's Office of Compliance Inspections and Examinations contacted a number of advisors seeking a broad swath of information on practices and policies with regard to class action claims filing. While those inquiries were informal in nature, they did highlight that the SEC and other regulators are paying attention to this area.

6. Liability – The Risks are Real

The costs of not filing, or not filing properly, can be high indeed. The institution of course suffers the direct hit of not recovering funds it has already lost and is entitled to claim. Both the institution and its management may suffer the costs of defending and possibly settling litigation over alleged breaches of fiduciary duty for failing to safeguard plan assets.

In January 2005, 40 mutual fund managers were sued by shareholders in class action lawsuits alleging that the funds had failed to collect nearly $2 billion in settlement payouts to which the funds (and the funds' shareholders) were entitled. The lawsuits alleged that the funds' failure to claim this money was a breach of the managers' fiduciary duty and a violation of federal law. The lawsuits sought compensatory damages for all of the money that the funds left on the table, punitive damages and the forfeiture of all commissions and fees paid by fund shareholders.

In 2007, an investment advisor took a $56 million charge as a result of having to reimburse certain clients and internal mutual funds for claims filing mistakes. The size of the missed claims for several of the mutual funds was significant enough to materially impact the NAV for those funds at the time of reimbursement.

Several years after that, various Wachovia and Wells Fargo entities were sued for allegedly failing to notify clients that they were members of a specific class action settlement class, and that as a result, those clients did not file claims and thus did not receive any proceeds. In denying a motion to dismiss that case in 2010, a federal judge recognized that a fiduciary relationship exists between the beneficial owner of securities and the nominee or record owners, and that such a duty could be breached by a failure to notify beneficial owners of class action settlements. While the parties eventually settled the case for a relatively minor sum, it took four years of distracting and hard-fought litigation.

These situations continue to pop up, with FINRA arbitrations and additional cases being filed in the ensuing years alleging essentially the same issues – a failure to notify clients or a failure to file claims where a fiduciary or contractual duty exists to do so.

7. Access to Data is Not Enough

Merely obtaining access to the data will be insufficient if the data will not provide the information needed to file and perfect a claim.A number of issues arise in the context of fund management and accounting systems and custodial relationships. We can highlight four in order to show the depth and breadth of the problems.

- At the time of a custodial transfer, the new custodian receives the positions in the portfolio, not the transactional history for the portfolio. The new custodian will therefore lack sufficient information to file and perfect a claim on behalf of the client.

- Custodial banks will overwrite historical transactional information when an issuer undergoes a CUSIP change. If the new CUSIP is not included in the class definition, because for example, the change was implemented after the end of the class period, a search on the "massaged" data for the included CUSIP (the old one) will not reveal any eligible transactions, thus potentially leading an investor to not file an otherwise eligible claim.

- Similar issues exist with bond maturities, where they are wiped from the prime broker's records a certain time after maturity. Again, a search for the correct CUSIP will not find the relevant transactions, as they have been removed from the records.

- Some vendor's systems will by default extract information with the settle date and not the trade date, resulting in incorrect data and possibly denied claims.

8. Solution #1- Have a plan

As a baseline, an institution needs to have a defensible policy for tracking and seeking recoveries via securities litigation. Such a policy should address the roles of both internal and external resources. Any policy should clearly spell out who is responsible for filing claims in settled matters on behalf of the institution. The policy should also spell out steps to be taken when changing service providers. If a fund merger or divestiture is contemplated, the policy should be adjusted to spell out responsibilities both before and after the event.

9. Solution #2 - Put it in writing!

The need for access to historical data should be addressed at the outset of the relationship with any service provider, such as a custodial bank, preferably in the contract. This will guarantee that an institution has the right to access their own historical data, for example to allow a third-party claims filing service to file claims on behalf of the institution. A custodian may insist on inserting a pre-negotiated fee structure for this access. While the propriety of that is best left to the parties to the custodial agreement, it is worth noting that it is far better to negotiate such fees at this point, rather than at the end of the relationship when the clock is ticking.

Additionally, it is important to understand the limitations that a custodian or other third-party filer may place upon their services. Most custodians will not file claims that include data that predates their custodial role. Many service providers impose minimum monetary loss thresholds before they will file a claim on behalf of an institution. At the other end of the spectrum, some service providers will not agree to caps on their so-called “success fees,” and may seek windfall profits from the claims filed on behalf of an institution.

10. Solution #3 – Avoid Pain by Creating Redundancy

There are compelling reasons to consider having a third party other than a custodian monitor your portfolio and file claims in settled cases. One is to ensure that the institution has a source for clean warehoused historical data. Another is to have a single consolidated service provider with a unified platform. This allows an institution the ability to view both active litigation recovery opportunities and more passive claims filing recovery opportunities.

11. Solution #4 - Use the power of many!

Global, systemic, standards for access to, and the "non-manipulation" of custodial data need to be put in place. This can be accomplished either through regulatory action, or through voluntary adherence to a set of principles. Such principles can be negotiated between institutional investor groups (e.g., the Council of Institutional Investors, National Conference on Public Employee Retirement Systems) and custodial organizations (e.g., the Association of Global Custodians or the Bank Depository User Group).

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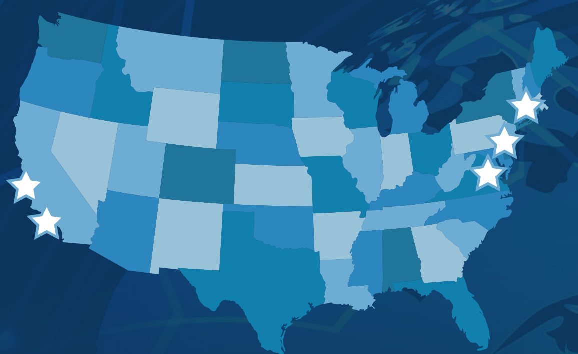
Adam Savett oversees Communications and Institutional Research for both Levi & Korsinsky LLP and CORE Monitoring Systems LLC. For more than 20 years, Adam has represented and advised some of the largest and most sophisticated institutional investors, government entities, individuals, and businesses in securities, antitrust, consumer protection, and other complex litigation.

Adam is a nationally recognized expert on complex litigation, class actions, and settlement claims filing. He is a frequent speaker, author, and commentator on class actions and securities litigation, and his comments have appeared in a wide variety of publications, such as The New York Times, Wall Street Journal, CFO Magazine, and Pensions & Investments.

Adam was previously named one of the 100 Lawyers You Need to Know in Securities Litigation by Lawdragon Magazine and has been an invited speaker before numerous industry groups, including the Federal Judicial Center (FJC), Bank Depository Users Group (BDUG), Association of Global Custodians (AGC), and SIFMA's Global Corporate Actions Forum.



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