

# Operational Alpha For Your Securities Litigation Recoveries

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**DIVIDEX<sup>®</sup>**

**OPAL:**

Opal has been running its Public Funds conference for many years, and we're proud to be a venue for an exchange of ideas and insights for you and your peers.

We appreciate that generating alpha for the portfolios you are entrusted to manage is a challenging task. Today, we are honored to be able to bring you an Opal Public Funds conference first.

Just weeks ago, The Teacher Retirement System of Texas and DIVIDEX completed a pilot project looking into the potential for generating Operational Alpha For Securities Litigation Recoveries. Today, we will be the first to hear what they found as they share with you the fiduciary challenges they hoped to address and the results of a first of its kind case study.

With that, I'm pleased to turn things over to our Keynote speakers, Lane and Irwin.

**LANE ARNOLD:**

Hello and good afternoon everyone! I am Lane Arnold, Assistant General Counsel at Teachers Retirement System of Texas and I am glad to be here with you today. In today's Keynote we are going to address the challenges for public pension funds in seeking to manage and improve outcomes from their exposures to securities class actions.

As we go through this, we will point out the questions public funds might ask their custodians or class action settlement claims filers. We'll point out the risks of not having an adequate system in place, such as missing settlement payments, and claim filer or claim administrator error leading to under recoveries. And we'll touch on compliance and operational challenges in accounting for funds received, including any requirement to repatriate the funds to the sub-account or sub-fund that suffered the losses.

And finally, we will share with you our findings from our Pilot Project that was designed to address these risks and generate additional revenues, what might be called "operational alpha" from this asset class.

**IRWIN SCHWARTZ:**

Thanks Lane! I'm Irwin Schwartz, President of DIVIDEX. To our knowledge, we're the only registered investment advisor founded to help institutional investors manage their exposures to securities litigation. Thanks to my old friend Catherine LaMarr and to Chase Rankin for their remarks earlier today and their focus on public pension fund fiduciary duties, especially as Chase mentioned, the duty to collect the funds that are due to you.

I know they and many of you attending today may have some familiarity with securities litigation. In the abstract, these exposures are somewhat like dividends. You own the stock. The stock price drops. Four or five years later you get two or three cents a share from a securities litigation payout, sometimes more. That's why we call the recoveries from these exposures "Dividex," for the extra dividend.

At our firm we think of exposures to investment-related litigation as an asset of our clients that can be managed just like any other plan asset: "To improve returns and minimize cost within an acceptable level of risk," to quote one of my law firm clients. Importantly, by doing this, it also helps meet fiduciary duties in managing exposures to these claims in the US and around the world.

Our firm's work has its roots in my legal practice in helping public pension funds to identify their entitlements to Dividex, and adopt a more disciplined approach to recovering Dividex and reconciling their recoveries. Some of my law firm public pension fund clients are in the audience today and I thank them for attending.

So, if you think about securities litigation exposures as an asset class, Lane and I are here to speak to you about the liquidity event stage —when you get paid on the assets — and offer some suggested steps to manage liquidity events for these exposures in your portfolios.

**LANE:**

Institutional Investor found this topic important enough to have focused on it twice. Their first feature article was titled THE ASSET CLASS NO ONE KNOWS THEY OWN. In their follow up piece, titled WHEN BIG FUNDS LAWYER UP, I was quoted about our efforts to get a case on file against Novo Nordisk in Denmark.

Irwin and I have arranged for you to get copies of these articles — as well as some notes on key take-aways from our talk — in a PDF handout you can download from us in this conference's Expo Room, at either the Texas Teachers or the DIVIDEX table.

**IRWIN:**

A housekeeping point — as a question occurs to you, please type them into the chat screen with enough time for the question to get through to us. I'm told there is a significant lag in the system, so please enter your questions during the course of our remarks. We'll address as many as time permits.

Lastly, since we have so many specific points and data we want to share with you — and a limited amount of time in which to share it in this virtual format — Lane and I will be speaking from notes to help guide our session with you today. And I apologize in advance if you see me peeking at these notes my remarks – I think Lane has memorized his.

**LANE:**

Many are under the impression that securities litigation recoveries are not material to their portfolios. But this is a huge market. So, let's start off by looking at some market losses to put this into context.

**IRWIN:**

The value of the asset is a function of the market losses that lead to securities litigation — and we track this across all equities around the world. In other words, it follows that large losses due to disclosure of securities fraud usually leads to securities fraud class actions and those are the asset class to which most have exposures in your portfolios. To get a handle on the size of this asset class — from the period of 2015-2019, there was over

\$2 trillion of market loss associated with 719 companies that were either sued for securities fraud or it appeared to us that securities fraud could have caused the market decline.

If you break that down to just the US market, you're talking about \$1.3 trillion of market loss across 409 companies, including cases against General Electric, Facebook and Google, which many of you have in your portfolios. For one client alone, those cases and potential cases were associated with billions (with a "B") of AUM losses. When you look at your losses across all actual and potential securities fraud cases around the world, you will see that the impact to your portfolios from those stock price declines is staggering. And that makes this asset class relevant.

On an annual basis — looking across all markets — we see that these types of cases lead to recoveries between \$5-10 billion a year, sometimes more; and those are revenues that belong to you, the investors. The challenge is to make sure you get your full share to reduce the impact of the market losses as best you can.

#### **LANE:**

At Texas Teachers we take very seriously our obligations to recover whatever we can on these claims and it can make a difference!

The average monthly annuity payment from our system is just over \$2,000. Viewed in those terms, the recoveries from these cases are material.

We have a fiduciary obligation to recover the monies owed us from securities class action settlements and to ensure we aren't leaving money on the table

While many focus on whether their plans might seek to be lead plaintiff or opt out or join a foreign case — and we do too at Texas Teachers — we want controls in place to assure that, when there is a securities class action settlement, we receive our full share of the common fund. We keep our eyes on the money.

That's why we agreed with DIVIDEX to run this pilot project: To test whether we could impose better controls to validate and reconcile our recoveries, make sure we are paid what is due to us, identify and quantify the situations in which we might be able to obtain more and take the opportunity for improvement from the status quo.

#### **IRWIN:**

Lane, on average about 125 of these cases settle per year. Based on my experience, custodians are generally good at getting the claims on file, but, to my knowledge, custodians have no way to reconcile recoveries! In practice, a case settles, the custodian puts together the transactions, submits them to the claims administrator either at the client level or account level and then waits for a check or checks, which could be a year or 18 months. When these payments are received, the custodian has no idea whether any check is in the right amount or the wrong amount or whether some transactions were excluded, or an account missed, or why.

In fact, we are aware of no controls at the custodial level to assure that the class action claims filed are recovered in full. In short, the custodians don't know how much the claim is worth and don't know whether any amounts received satisfy the amount due to their clients.

In other words, it is not safe to simply rely on the custodian to assure that plan sponsors recover all that is due them from class action settlement.

**LANE:**

Irwin, to get more granular, managing these exposures requires you to ask the first question, How are class action recoveries being done for you? My job at Texas Teachers is to ask that question and come up with the answer.

Then you ask, Is there a prudent way to make sure that claims filing and recovery is being done properly and that makes sure that you're getting everything that is due to you? And then finally, something that I've been focusing on recently, as you will hear, How do you make sure that the money received goes into to the right account?

**IRWIN:**

First off — and our audience will find our survey directly relates to these questions — Most funds rely on their custodians to perform these functions, but have few if any controls to assure that the custodian is properly undertaking these tasks. So:

- Does the claims filer have good systems to alert it to all settlements for which you are entitled to a recovery? Most are very good at identifying entitlements and funds have systems in place to check this function.
- Did custodian claims filer submit all transactions necessary to obtain the maximum recovery? Most plan sponsors have no way to determine this on their own and there have been no services that provide analytics in that regard. – If you are aware of such a service that tracks custodial filing to ensure all transactions were properly submitted, please post it in the chat feature.
- Were the settlement funds received in the correct amount for all qualifying trades? Most plan sponsors have no way to determine this, not even the custodians know this, and I am aware of no analytical service to assure of this fact.
- Were the funds repatriated to the correct account? This one is really a killer. Most plan sponsors have no way to determine whether the right amounts were deposited into the correct account, which is especially important for those that require repatriation to the investment manager or account that lost assets due to the alleged fraud.

**LANE:**

So, what could go wrong? Custodial data could be incomplete: The Pilot Project demonstrated that tax free zero basis transfers, market value transfers, buy and buy cancels and sell and sell cancels — none of which are true trades — all have an impact on entitlement. Do the custodians clean these up? Do the claims administrators clean them up?

**IRWIN:**

The Pilot Project told us that sometimes neither cleans them up, and sometimes it makes a difference. Even if the custodian gets all the correct data filed for a claim, the claims administrator could make a mistake.

Mostly the claims administrator is accurate, but in our evaluation, we found that sometimes claims administrators under pay. You, the investor, have no way to know. Not even the custodian would know because there's no reconciliation.

Every year Custodians receive hundreds of millions of dollars in physical checks from securities class action settlements. We found, as Lane will tell you, that custodians could and do make mistakes in depositing these funds. We found other instances in which the checks were never deposited. What if the Custodian deposits the check into the wrong account or the check itself refers to the wrong investor name or only partially states the account title and not even custodian can figure it out? Who would know and how would you find it?

**LANE:**

Absolutely, Irwin! Let me tell you, these are the kinds of issues that keep us up at night.

**IRWIN:**

These are the core questions for managing this asset class. If your fund doesn't have answers to these questions, it might raise compliance issues.

And I agree with Lane that a big part of the question is "prudence." Put another way, is there a fiscally responsible way to address these questions? For those of you grinding your teeth because you don't have systems in place to address these issues, you are not alone because, prior to the Texas Teachers pilot program, we don't think there was any prudent way for plan sponsors to internally address these questions.

That led us to recommend third-party claims filing services that do have processes to reconcile recoveries against what is due, but some funds consider these filing service to be expensive. And if you rely entirely on the filing service to file claims, receive payments and reconcile recoveries, that still does not provide independent analysis to assure that you are getting everything that is due to you.

**LANE:**

At Texas Teachers, we don't want to pay for a third party to perform the same filing services that are already bundled into the custodial contract unless we could expect the program to at least pay for itself, and hopefully generate returns far beyond its costs. That's why we agreed to the DIVIDEX pilot program, to test for that justification.

**IRWIN:**

Based on our work for other public pension funds, we believe that better management of the class action settlement recovery process will lead to increased recoveries as compared to the status quo of the un-managed claims filing and payment repatriation process relying solely on custodians. I call that "standing instructions" because most plan sponsors that rely on their custodians have the "standing instruction" to file claims either on the account level or the client level unless the client intervenes, such as when it decides to opt-out of a case.

We believe that recoveries can be improved using more sophisticated claim filing analytics to seek to improve the valuation of the claim as compared to the standing instructions. We call this improvement OPERATIONAL ALPHA.

To Lane's point, the DIVIDEX pilot program for Teachers sought to answer a particular question: Can a plan sponsor find missing payments that may be due it — and improve recoveries from securities class action settlement claims filings — all the while leaving the bulk of claims filing with its custodian under its standing instructions?

Based on the results of the pilot project the answer is Yes.

### **LANE:**

It was very important to us to identify any Missed Payments Due to us. Over the years we have checked to make sure the custodian is filing claims for Teachers in all cases that we think they should be, and we have seen that they do a very good job on case coverage. But that's about the full extent of "double checking" you can do when you are relying solely on the custodian to handle the process end-to-end. Reporting, for example, can become a bit of a feedback loop, and there is no way to conduct any independent reconciliation of what was filed and what should have been received in connection with a particular filing.

For this reason, Irwin really got my attention when he called about halfway through the Pilot Project to say that he wasn't seeing a large check in the reporting that his analysis was indicating should be there.

With respect to payment reconciliation, the Pilot Project evaluated 13 of our largest settlement recoveries in 2019 and early 2020 and identified five cases in which the total reported settlement payments were almost \$900,000 below expected payments.

The bulk of this shortfall was associated with a missing payment to a single Teachers account in one particular case: the case Irwin got my attention with when he called. Based on the preliminary DIVIDEX report of these findings, we did some digging and actually discovered over \$1 million in incorrectly deposited class action recoveries were just sitting there in an orphaned, non-interest bearing account!

Those funds have now been repatriated to the proper account. Without the DIVIDEX review, we never would have known, and that money — which represents about 500 annuity payments to retired Texas teachers — would probably still be sitting there in purgatory!

I am by nature a bit of a cheapskate, so when I think about these cases, I often talk to my colleagues about turning our pockets inside out or reaching behind the couch cushions to find all the savings and additional recoveries we can.

So, consistent with this theme — in addition to reconciliation and oversight — in the Pilot Project we were interested in learning if by using more sophisticated analytics we could actually increase Texas Teachers' share of recoveries.

### **IRWIN:**

During the pilot project, DIVIDEX evaluated 129 settled cases from February 2019 to February 2020, and conducted an in-depth analysis of 85 cases. We identified 25 cases as to which we believed that Teachers could have improved the filings as compared to the standing instructions. Some of these represented opportunities to add significant value.

## **LANE:**

Here is what we learned: Over the one-year study period of the pilot project, the proposed new analytics and filing methods could have increased Texas Teachers' share of recoveries by about 11% across all 85 cases DIVIDEX analyzed. We expect — based on our historical annual recoveries — that this will equate to about \$1 million more dollars per year to Teachers over time out of securities class action settlements.

As you all can appreciate, finding an extra \$1 million on existing investments — and an improvement of 10+ percent on any asset class — is remarkable!

## **IRWIN:**

This demonstrates that disciplined management of securities class action settlement claims exposures with an eye to improve the status quo will generate operational alpha over time.

For a little background, prior to starting the pilot project, DIVIDEX had developed tools that allow us to analyze claims filing data and reconcile outcomes. In the pilot project we adapted those tools to seek to optimize claim filings by comparing the claim valuation under the standing instruction method of filing with the claim valuation after “conditioning” the transactional data, such as correcting inter-account tax free zero basis transfers, adjusting for market value transfers, buy and buy cancels, and sell and sell cancels. In short, depending on each client's trading patterns and the exact requirements of court-ordered plans of allocation, it may make a difference.

While most institutional investors have no way to undertake these analyses themselves, the secret ingredient, which is no secret at all, to calculate “recognized loss” for each settlement based on the investor's transaction history under the court-ordered plan of allocation. It is a difficult process and to my knowledge the custodians and some third party claims filers disavow it, probably because there is too much risk in getting it wrong or maybe it is just too resource intensive.

But the recognized loss for each account or for the client, depending on how you file, creates a common numerator for every pro rata distribution. This allows for the comparative calculation of the value of the claim by recognized loss with the data in its raw state or “conditioned,” either by account or at the client level. Calculating recognized loss also allows for reconciliation of recoveries to determine whether they align with the pro rata share of recognized loss received across all accounts. That way you will know if one or more of your accounts or your entire claim did not receive full value.

The ability to calculate recognized loss based on trading history, allows the plan sponsor to establish controls over most aspects of this process. In short, the way we found that a check was missing as Lane just reported is we calculated recognized loss for every account that Texas Teachers custodian filed in that case. We then compared what the custodian actually repatriated to Texas Teachers' accounts and aligned the recoveries with the recognized losses. That uncovered the missing check and that led to generating operational alpha!



## **LANE:**

The way we've envisioned this working, you could analogize to how your fund may trade FX. Lots of funds have FX standing instructions with the custodian and an FX consultant. For most transactions, the fund will rely on the custodian to clear FX transactions under your standing instructions, for example when settling small trades denominated in foreign currencies or repatriating dividends paid on foreign stocks. But for bigger FX trades, a fund may rely on its investment managers or an FX consultant to seek to get better execution rates, hopefully that day's best rate on the relevant currency pairs. We think the exposures to securities litigation recoveries can be managed in much the same way, with the custodian handling most filing and the plan only stepping in when there are opportunities identified by DIVIDEX to increase efficiency or maximize a recovery.

For small exposures, consider leaving it to the custodian and perhaps spot check filings and recoveries for internal controls purposes. For large exposures, use expertise to evaluate whether it makes sense to take the filing away from the custodian. And for all large recoveries, use recognized loss to reconcile against expected recovery amounts.

As for our next step at Texas Teachers, we are currently discussing with Irwin and his team the best way to implement this system.

## **IRWIN:**

Thanks Lane! It's great to work with you and Teachers, which takes its fiduciary duties so seriously and is a thought leader in so many aspects of investment stewardship.

I'd also like to recognize two other innovative public pension funds, the work for which was the foundation for this pilot project: Mass PRIM and CalSTRS. This work started with a PRIM pilot project in 2013, seeking to improve its securities litigation recovery process. CalSTRS asked us to undertake oversight of its third-party filer, the software tools for which served as the starting point for the Texas Teachers pilot project.

Finally, I'd like to thank Opal for paying attention to portfolio-related litigation exposures as an asset. I've had the honor of being a keynote speaker on this topic at the last Opal conference for Public Pensions.

With all due respect to the private fund complexes — some of which plug their ears and start humming when you mention fiduciary duty with respect to these exposures — it is the public pension funds that are working to bring greater accountability to the little slice of their equity portfolios that is kind of like dividends, which is subject to massive transaction costs, but that is a theme for another panel!

We thank you for your time and we'll take a look now to see if anyone posted a question they wanted us to respond to.

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