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New Focus on "Securities Lending" in Pension and 401(k) Plan Investment Funds

Several recent lawsuits have drawn new attention to an investment practice used by many retirement plan funds. "Securities lending" programs are very common among financial institutions that invest assets of tax-qualified pension and 401(k) plans.

Pension and 401(k) plan investment committees and other fiduciaries should determine whether any of their portfolios engage in securities lending and, if so, how their plans might be affected in the current environment.

The financial crisis has caused some securities lending programs to experience losses or devaluations in their portfolios for the first time. This has also lead to liquidity problems for some funds. For example, because of issues with its securities lending program, State Street has limited plan sponsors' ability to move out of certain of its investment funds. Participant-level restrictions are possible as well.

Lawsuits have been filed against State Street, Northern Trust, JPMorgan Chase and Wells Fargo in connection with their securities lending programs. Published reports have also indicated issues with securities lending programs of Barclays and Bank of New York Mellon. Undoubtedly, these practices, and the potential exposure, are not limited to this group.

Background. Securities lending in retirement plan funds has been around for a long time; in the early 1980's, the U.S. Department of Labor issued prohibited transaction exemptions clearing the way for widespread utilization of securities lending by ERISA retirement funds. Initially, these programs produced modest additional income for retirement plans. However, securities lending arrangements have evolved and become increasingly complex over time, and it is now apparent that some securities lending involved an unexpected element of risk.

What is Securities Lending? In a typical securities lending transaction, stocks or bonds held in an investment fund or portfolio are loaned to another party, typically a broker-dealer or short seller, in return for a fee. The borrower delivers collateral to secure the loan, and cash collateral is invested. At the end of the loan period, the borrower returns the securities, and the lending fund must return the collateral amount to the borrower.

Impact of Current Financial Climate. Traditionally, most securities lending programs invested the collateral in conservative investments focused on principal preservation. However, over time, in search of additional revenues, some managers of securities lending programs increased the risk profile of the arrangements by investing collateral more aggressively.

In recent years, some financial institutions have invested collateral in illiquid or highly leveraged investments, including mortgage backed securities and other securitized debt instruments that do not mature for many years. The market values of many of these investments have been significantly reduced as a result of the current credit and liquidity crisis.

Fees Associated with Securities Lending Programs

Though issues relating to investment of collateral have, thus far, attracted the most attention, another potential issue with securities lending programs relates to the fees involved.

Fees collected from borrowers, and in some cases returns on invested collateral, are shared by the financial institution that manages the securities lending program and the retirement plans that invest in the fund. The financial institution that sponsors the program may participate only in positive returns, with losses to be borne fully by the retirement plans. ERISA's prohibited transaction, conflict of interest and fiduciary rules must be satisfied in connection with such fee arrangements.

In some instances, securities lending programs have incurred actual losses when these riskier investments defaulted. More commonly, sponsors of securities lending programs have attempted to avoid realizing losses by imposing restrictions on withdrawals and transfers from the investment fund.

Questions for Plan Fiduciaries. In some cases, securities lending programs are creating very significant liquidity, valuation and other problems. Retirement plan fiduciaries (such as an investment committee) whose portfolios are affected by these issues face a number of potential problems. Plan fiduciaries should take action now to understand the securities lending programs they are involved in and to protect themselves from personal liability. These steps should include careful consideration of each of the following:

- Whether the terms of the plan and trust (and related) documents have been followed in connection with securities lending activities;
- Whether portfolios involved in lending securities reflect proper valuations;
- Whether participation in a securities lending program on behalf of a plan should be discontinued, or if continued, on what terms;
- Whether disclosures should be made to participants in 401(k) plans with participant-directed investments that may be adversely affected by securities lending activities;
- Whether plan trustees/custodians, investment managers or other investment fiduciaries have failed to fulfill their fiduciary duties with respect to the plan or otherwise acted improperly in lending securities;
- Whether there have been potential ERISA prohibited transactions, or other conflict of interest transactions, in connection with securities lending and compensation paid to service providers in connection with the program (see the sidebar for more information on this issue); and
- Whether fiduciary duties obligate plan fiduciaries to seek to recover or restore any losses suffered by a plan at the result of improper activities by other fiduciaries.

Investment committees and other retirement plan fiduciaries are encouraged to determine whether any of the funds or portfolios in which their pension or 401(k) plans invest have engaged (or are permitted to engage) in securities lending. For those plans that do participate in securities lending, a review of the funds' securities lending practices, and the impact of those practices on the plans' investment portfolios and participants' accounts, should be considered.

Contact Information. For additional information or for questions relating to securities lending issues, please contact Glenn Infinger (404.888.8845), David Putnal (404.888.8836) or Toby Walls (404.888.8870).