

**Report of the**  
**South Carolina Public Employee Benefit Authority**  
**to the**  
**Chairman of the Senate Finance Committee**  
**and the**  
**Chairman of the House Ways and Means Committee**  
**Regarding the Settlement of**  
*The State Treasurer of South Carolina et. al. v. The*  
*Bank of New York Mellon Corporation and the Bank*  
*of New York Mellon*

**January 12, 2015**

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## **INDEX OF EXHIBITS**

- Exhibit #1**      **Settlement and Mutual Release Agreement (“Settlement Agreement”)**
- Exhibit #2**      **2007 Global Custody Agreement**
- Exhibit #3**      **2013 Custody Agreement**
- Exhibit #4**      **2000 Securities Lending Agreement and Guaranty**
- Exhibit #5**      **2014 Securities Lending Authorization Agreement**
- Exhibit #6**      **Litigation Retention Agreement for Special Counsel Appointed by the South Carolina State Treasurer; Addendum to Litigation Retention Agreement for Special Counsel Appointed by the South Carolina State Treasurer; Letter dated May 2, 2013, from the South Carolina Attorney General to the State Treasurer**

## I. INTRODUCTION

Between January 2011 and May 2013, the State of South Carolina, through the State Treasurer, was involved in litigation with the Bank of New York Mellon (“BNYM”) related to certain losses suffered in 2008 and 2009 by the funds held in custody by the Treasurer as a result of the participation of those funds in the securities lending program offered by BNYM. The litigation was ultimately concluded by a settlement agreement executed by the parties on May 14, 2013, in which BNYM agreed to make certain cash payments to the State and its attorneys and the State Treasurer agreed to continue its custodial relationship with BNYM with certain pricing considerations from BNYM.

In late 2013, the Senate Finance Committee commissioned a Special Subcommittee to Review the Investment of State Retirement Funds to conduct hearings and review a number of matters concerning the investment of the funds of the State’s retirement systems, including review of the settlement reached in the securities lending litigation with BNYM. During the hearings held by the Special Committee in early 2014, the Committee received conflicting testimony and evidence regarding the value of the settlement to the State’s retirement systems. In particular, in its final report, the Committee noted that:

The real value of the settlement is a point of contention. The Treasurer asserts that this arrangement with BNYM is of significant value over an extended period of time. In contrast, the staff of the Investment Commission view the value of the settlement as solely the cash payment of \$25M[.]<sup>1</sup>

In light of that contention, under a proviso in the 2014-2015 Appropriations Act, the South Carolina Public Employee Benefit Authority (“PEBA”) was directed to:

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<sup>1</sup> “A Report by the Special Subcommittee to Review the Investment of State Retirement Funds,” April 1, 2014, page 10.

submit to the Chairman of the Senate Finance Committee and the Chairman of the House Ways and Means Committee . . . a report on the settlement between the State of South Carolina and the Bank of New York Mellon that provides review and comment upon the benefits of the settlement for the employees and retirees of South Carolina.<sup>2</sup>

The following is PEBA's report.

## **II. EXECUTIVE SUMMARY**

By statutory designation, the State Treasurer holds custody over a wide variety of governmental funds in South Carolina, including the assets of the State itself, the assets of the State retirement systems' trust funds, the assets of various state institutions and political subdivisions, and the assets of a number of other funds, including the State's health insurance trust funds. In this custodial role, the Treasurer has, for many years, contracted with the Bank of New York Mellon ("BNYM") and its predecessors to provide custodial services, including securities lending services, for the funds held in custody by the Treasurer. During the financial crisis of 2008 and 2009, the funds held by the Treasurer, including the State's retirement systems' funds, suffered significant losses in the cash collateral invested for those funds as part of BNYM's securities lending program. As of June 30, 2009, the portion of these losses allocated to the retirement systems was \$222 million. A material portion of this loss has not been recovered to date.

In January 2011, the State Treasurer, who was later joined by the Attorney General, brought suit against BNYM in South Carolina alleging breach of contract and breach of fiduciary

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<sup>2</sup> Act 286 of 2014, Part IB, Section 105.13. This proviso further authorized PEBA to "retain independent expert assistance, including legal counsel of its choosing," in conducting the review and preparing the required report.

duty in BNYM's operation of the securities lending program, resulting in the losses to the funds held in custody by the Treasurer. PEBA was not created until July 2012 and was not a party to the litigation. To conduct the litigation, the Treasurer, with the approval of the Attorney General, retained outside counsel on a contingency fee arrangement. After conducting extensive discovery and contesting several motions, the parties entered into a Settlement Agreement in May 2013 to bring the litigation to a close. Although some impaired assets had recovered partial value while the litigation progressed, the retirement systems still had a loss and resulting liability of \$90 million on its balance sheet at the time of the settlement.

The potential sources of benefits for the retirement systems in the Settlement Agreement can be grouped into three categories: (1) the cash payments made by BNYM to the funds held in custody by the Treasurer and to the State's attorneys; (2) the pricing considerations promised by BNYM in connection with the continuation of the custodial banking and securities lending relationship with the Treasurer for an additional ten-year period; and (3) BNYM's release of claims against the State, potentially including any obligation of the retirement systems to pay funds to cover the deficiency in the systems' cash collateral reinvestment account. Having reviewed these potential sources of benefits, PEBA has concluded that the benefit of the Settlement Agreement to the employees and retirees of the State of South Carolina consists principally of the cash payments made by BNYM to the cash collateral reinvestment account for the State's retirement systems and BNYM's payment of legal fees to the State's outside counsel. The total value of these payments, as allocated to the retirement systems' funds, is approximately \$23,523,895.90, which represents the total of the \$20,039,375.90 credited to the retirement systems' securities lending account and \$3,484,520 in attorneys' fees that would have been payable from the funds recovered by the retirement systems under the original litigation retention

agreement if not for BNYM's agreement to directly pay \$9 million in attorneys' fees to the State's outside counsel. With regard to various pricing considerations related to the Treasurer's agreement to engage BNYM to provide continued custodial and securities lending services for an additional ten-year period, PEBA assigns little value to those pricing considerations, as most of those services and fees were already offered to the Treasurer by BNYM during the public solicitation for a new custodial contract in 2012 and a number of other services, including those associated with BNYM's HedgeMark products, are of no interest to the South Carolina Retirement System Investment Commission ("RSIC") or PEBA. Finally, if the release provisions of the Settlement Agreement relieve the retirement systems of any obligation to pay funds to cover the remaining deficiency in the systems' cash collateral reinvestment account, the value of the Settlement Agreement would be materially enhanced. However, as the question of the proper application of the release provisions remains unresolved at this point, PEBA cannot assign a value to the release provisions of the Settlement Agreement as of the date of this Report.

It should also be noted that among the other funds held in custody by the State Treasurer, and potentially benefiting from the Settlement Agreement, are the funds of the State's Retiree Health Insurance Trust Fund and Long-Term Disability Insurance Trust Fund. In the preparation of this Report, PEBA has made inquiries with the Treasurer's office to ascertain the proper accounting of the securities lending gains and losses attributable to these trusts and to determine what portion of the payment under the Settlement Agreement was allocated to those funds. However, to date, the Treasurer's office has not been able to provide the requested accounting, and PEBA cannot offer comment on the benefit, if any, of the Settlement Agreement for those funds at this time.

### **III. CASE BACKGROUND**

As a framework for its analysis of the benefits of the settlement, PEBA provides the following discussion of the custodial and securities lending relationship between the State and BNYM<sup>3</sup>; the events leading to the losses in 2008 and 2009; the basis of the State's claims against BNYM; relevant events during the course of the litigation; an assessment of the State's potential recovery in the litigation; and a survey of similar cases.<sup>4</sup>

#### **A. The Custody and Securities Lending Relationship**

Today, most securities are electronically registered and transferred, rarely does an institutional investor, like a state retirement system, take possession of certificates evidencing ownership of invested funds. Instead, it is customary for custodians for such investors to enter into custodial agent agreements with banks or other financial institutions such as BNYM. In connection with such custodial agreements, it has become increasingly common for states and other institutions to engage in securities lending activities.

Generally, when securities are loaned to a borrower, the borrower is required to give the lender collateral in the form of cash or cash-equivalents equal to 102% (or more, in some cases) of the value of the securities loaned. The lending agent, in this case BNYM, is responsible for

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<sup>3</sup> Where relevant in this report, the acronym "BNYM" shall also be understood to include its predecessor, the Bank of New York.

<sup>4</sup> It is important to note that, in reviewing this litigation and other similar litigation, PEBA faces certain limitations. In most securities lending cases, the parties to the litigation entered into confidentiality and protective orders that restricted the parties from revealing information exchanged in written discovery and in deposition, absent court order or consent of all parties to the protective order. Likewise, in this matter, the State and BNYM entered into a protective order, which contained similar restrictions on their ability to provide access to information exchanged in the case to third-parties, such as PEBA. In addition, the staffs of the Office of the State Treasurer, the Office of the Attorney General, and the RSIC have been mindful in their discussions with PEBA to protect and to avoid inadvertent waiver of the attorney-client privilege.



assuring the collateral remains adequate to cover the value of the loaned securities as they fluctuate in market value, and to reinvest the collateral to obtain an additional return for the owner of the securities. Historically, securities lending has been used to provide relatively small, but relatively limited-risk, returns.

In South Carolina, the State Treasurer serves as the custodian of the funds and assets of the State and its agencies and subdivisions, as well as custodian of the funds held in trust for the State's employee benefit plans, including, most notably, the State's retirement systems.<sup>5</sup> With regard to the State funds held and invested by the Treasurer, Section 11-9-660(B) of the South Carolina Code of Laws authorizes the Treasurer to "contract to lend securities invested" under his investment authority.<sup>6</sup> The authority to conduct securities lending activities with regard to the retirement systems' trust funds resides with the RSIC, which has historically exercised its authority to participate in securities lending in conjunction with the Treasurer's custodial arrangements.<sup>7</sup> Dating back to the mid-1990s, the Treasurer has used BNYM as the custodial bank for the funds he holds in custody, including both State funds and the trust funds of the State's employee benefit plans, and has participated in the securities lending program offered by BNYM in connection with those funds.

At the time of the losses in the securities lending program that gave rise to the litigation, the relationship between the State Treasurer and BNYM was governed by a custody agreement

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<sup>5</sup> See generally, e.g., S.C. Code Ann. § 11-13-10 *et seq.* (Supp. 2014) (providing for the deposit of State funds with the Treasurer); S.C. Code Ann. §§ 1-11-705(B), 1-11-707(B) (Supp. 2014) (designating the Treasurer as custodian for the funds held in the retiree health insurance and long-term disability insurance trust funds); S.C. Code Ann. §§ 9-1-1320, 9-8-170(1), 9-9-160(1), 9-10-80(A), 9-11-250(1) (Supp. 2014) (designating the Treasurer as custodian for the funds of the State's retirement systems).

<sup>6</sup> S.C. Code Ann. § 11-9-660 (Supp. 2014); *see also* S.C. Code Ann §§ 1-11-705(G)(1), 1-11-707(G)(1) (Supp. 2014) (authorizing the Treasurer to invest and reinvest the funds in the retiree health insurance and long-term disability insurance trust funds "in the manner allowed by law").

<sup>7</sup> See S.C. Code Ann. §§ 9-16-20(A), 9-16-315(G) (Supp. 2014).

executed in 2007 and a securities lending agreement executed in 2000. The custody agreement had been executed on April 27, 2007, to replace the existing custody agreement between the State Treasurer and BNYM as the result of the merger of the Bank of New York with Mellon Bank. As had been the case under the former agreement, under the 2007 custody agreement, BNYM waived all custody-related fees and out-of-pocket expenses in exchange for receiving a share of the securities lending earnings on the State's account.<sup>8</sup> The Securities Lending Agreement and Guaranty ("SLA") had been executed on March 24, 2000, between the State Treasurer and BNYM. The securities lending agreement authorized BNYM to lend the securities held in custody by the Treasurer and to invest on behalf of the Treasurer the collateral received for the loaned securities. BNYM's authority to invest the collateral was subject to various restrictions, including limitations on the type, credit quality, interest rate risk, and maximum maturity date of the investment. At the outset of their relationship, BNYM received a fee for lending the securities and reinvesting the cash collateral equal to twenty-five percent (25%) of the earnings. Over time, that fee was reduced; by 2008, BNYM's fee was fifteen percent (15%) of the earnings.

In late 2011, after the litigation had been filed against BNYM, the State Treasurer issued a Request for Proposal for Master Custody Bank and Securities Lending Services. Several banking institutions, including BNYM, submitted proposals in response to the solicitation, and those responses were reviewed and scored by an evaluation committee. However, a new contract for custodial and securities lending services for the funds held in custody by the Treasurer was

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<sup>8</sup> BNYM was, however, entitled to certain ancillary fees for attribution analysis, and, to the extent requested by the South Carolina Retirement Systems, other fees for ancillary analytical and reporting services beyond the scope of services included in the basic custody agreement. However, no fees had ever been paid for such ancillary services.

not concluded pursuant to this solicitation process. Rather, as discussed below, new agreements for custodial and securities lending services were procured from BNYM as a part of the settlement of the litigation.

**B. The Securities Lending Losses of the Retirement Systems**

As is now well-known, on September 15, 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection. The “housing bubble” burst, and significant losses were suffered throughout the markets for equities, bonds, other debt instruments, and other types of investments. By the end of the State’s fiscal year on June 30, 2009, the State’s retirement systems had a loss or deficiency in its securities lending collateral reinvestment account of almost two hundred and thirty million dollars (\$230,000,000). More than two hundred and twenty-two million dollars (\$222,000,000) of that loss or deficiency were related to investments in notes issued by Lehman Brothers and to investments in various asset-backed securities (“ABS”) in which the assets backing the securities primarily consisted of sub-prime mortgages. The other funds held in custody by the Treasurer, including funds of the State and certain agencies and subdivisions, also had losses from Lehman notes and ABS, although in amounts smaller than those of the retirement systems.<sup>9</sup>

**C. The Litigation**

Beginning in 2009 and continuing until the action was filed in January 2011, the State Treasurer’s office, with assistance from the RSIC, sought information from BNYM to determine the nature of the investments BNYM had acquired using the securities lending collateral of the

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<sup>9</sup> Among the other funds held in custody by the Treasurer that suffered losses in the securities lending program in 2008 and 2009 were the funds of the Retiree Health Insurance Trust Fund and the Long-Term Disability Insurance Trust Fund. The accounting of these losses and the benefit of the Settlement Agreement for those funds is addressed in greater detail in footnote 11 below.

funds held in custody by the Treasurer, including the retirement systems' funds, and to evaluate the prospect that those investments would recover in value. As discussed in more detail in the damages section below, in the fall of 2009, the RSIC decided to transfer the ABS portfolio in the retirement systems' collateral reinvestment account from BNYM to a different financial institution, Strategos Capital Management, LLC ("Strategos"), after concluding it was better situated to maximize the value of that portfolio. During the same time period, the State Treasurer sought legal advice from the Attorney General's office and outside counsel to determine whether the State had legal recourse against BNYM to recover some or all of its losses. During 2010, the State made efforts to discuss a settlement with BNYM, but those efforts were fruitless. Subsequently, in January 2011, the Treasurer filed an action against BNYM in the Richland County Court of Common Pleas, styled The State Treasurer of the State of South Carolina v. The Bank of New York Mellon Corporation and the Bank of New York Mellon.<sup>10</sup> In the complaint, the Treasurer alleged breaches of contract and fiduciary duty by BNYM and sought damages related to the losses suffered by the funds held in custody by the Treasurer as result of their participation in BNYM's securities lending program. To conduct the litigation, the Treasurer, with the approval of the Attorney General, obtained the services of outside counsel under a contingency fee agreement.

As the litigation progressed, the parties engaged in various pre-trial matters, including filing and defending motions to dismiss and participating in extensive discovery. In particular, early in the litigation, BNYM filed several motions in an attempt to have the action dismissed, claiming variously that the State Treasurer was not the real party in interest entitled to bring the action; that the State Treasurer was not authorized to engage private legal counsel to bring the

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<sup>10</sup> As noted below, the complaint was amended in March 2013 to add the South Carolina Attorney General as a plaintiff in addition to the State Treasurer.

claims; and, for various reasons, that the action failed to state claims upon which relief could be granted. In response to the motions to dismiss, the South Carolina Attorney General joined the action as a plaintiff, and these motions were denied. Further, both before and after BNYM's motions were heard, the parties engaged in substantial discovery, exchanging approximately five million pages of documents and taking over thirty-five depositions.

**i. Basis of the State's Claims against BNYM**

**a. Claims related to BNYM's Investment of Cash Collateral in  
ABS**

Because BNYM had invested the cash collateral returned from the lending of the securities held in custody by the Treasurer in ABS backed by mortgages with thirty year maturity dates, the State alleged BNYM breached the SLA's limitation that, for ABS, the maximum final maturity could not exceed three years, and the maximum weighted average life could not exceed 1.5 years. The State also alleged it could not have known of BNYM's breach until 2009 when it became aware of and began investigating the ABS losses because, prior to that time, BNYM's reports to the State failed to disclose sufficient information from which it could have been determined that the ABS portfolio was backed by mortgages with maturity dates significantly longer than allowed under the SLA.

**b. Claims related to BNYM's Investment of Cash Collateral in  
Lehman Notes**

BNYM's investment of cash collateral in Lehman notes, purchased in 2006 and 2007, ostensibly met the SLA's limitations regarding the types of investments BNYM was allowed to make with the cash collateral returned from the lending of the securities held in custody by the Treasurer. At the time of the investments, Lehman met the SLA's required credit ratings from

Standard & Poor's and Moody's, and the investments met the SLA's interest rate risk and the loan maximum maturity limitations. However, because BNYM, for its own account and for some of its non-custodial customers, began reducing exposure to Lehman notes well before Lehman's bankruptcy, the State alleged BNYM breached its duties by not liquidating the cash collateral investments in Lehman notes belonging to the funds held by the Treasurer as well, and by not warning the State of the risks related to holding those notes, when it knew or should have known those securities were likely to become impaired.

**ii. BNYM's Defenses to the State's Claims**

In addition to the grounds for dismissal argued by BNYM in its motions, BNYM raised several defenses to the claims stated by the State in the litigation. One of these defenses was that the applicable statutes of limitation barred certain of the State's claims. Specifically, in February 2013, BNYM provided the State with an affidavit of former State Treasurer Thomas Ravenel, in which he asserted he and his office knew in 2007, more than three years before the action was filed, that BNYM had been investing funds held by Treasurer in ABS backed by mortgages with a thirty-year maturity date. If a judge or jury were to believe this testimony, there was a risk that the ABS-based claims could have been rejected as time barred. In a defense to the State's claims that BNYM should have liquidated, or advised the Treasurer to liquidate, the Lehman portfolio before Lehman's bankruptcy, BNYM asserted that other facts evidenced that the State, through other advisors, had decided that retaining investments in Lehman was appropriate at the time in question. In particular, through discovery, BNYM learned that another outside manager of retirement systems' funds had invested in Lehman notes and had not liquidated that investment before the Lehman bankruptcy, and that retirement systems' assets had been invested in an

interest-rate swap transaction in which Lehman was a counterparty during the period prior to the Lehman bankruptcy.

**iii. Potential Damages**

**a. Losses associated with the ABS Portfolio**

As of June 30, 2009, the original cost of the ABS portfolio then held in the retirement systems' securities lending account was \$340,246,748. Although not all of the ABS were severely impaired, most were, and the market value on June 30, 2009, of the portfolio of ABS was \$247,440,190, representing an unrealized loss of \$92,806,559.00. Because the value of the portfolio fluctuated from day to day, the losses associated with the portfolio fluctuated as well. Certain ABS investments that were not seriously impaired were liquidated, others recovered somewhat in value, and still others matured and were paid in full. On October 7, 2009, the RSIC transferred the remaining ABS portfolio from BNYM to Strategos. At that time, the original cost of the ABS transferred was \$282,100,064.87, and the market value of the ABS transferred was \$207,012,076.20. Upon withdrawal of the portfolio from BNYM, the retirement systems realized a loss of \$75,087,988.67, and transferred cash out of the retirement systems' trust funds to cover the loss.

**b. Losses associated with the Lehman Brothers Note Portfolio**

The original Lehman note investment in the retirement systems' collateral reinvestment account totaled \$129,750,000.00. As with the ABS portfolio, the value of the notes fluctuated, and so the potential loss varied from day to day. As of June 30, 2009, the end of the State's fiscal year during which Lehman Brothers filed bankruptcy, the unrealized loss was \$110,611,875.00. Various events subsequently occurred that reduced that loss: (1) on April 17, 2012, the retirement systems recovered \$7,790,717.14 on the portfolio as a result of the Lehman

bankruptcy proceeding; (2) on May 3, 2012, a group of Lehman Brothers notes was sold, from which the retirement systems received \$10,697,887.50; (3) on August 21, 2012, a second group of Lehman Brothers notes was sold, from which the retirement systems received \$4,382,203.03; and (4) on September 10, 2012, the remaining Lehman Brothers notes were sold, from which the retirement systems received \$16,631,831.87. Taking these recoveries into account, on its original \$129,750,000.00 Lehman note investment, the retirement systems had suffered a net loss of \$90,247,360.46 as of the time of settlement.

While the foregoing calculations may suggest the retirement systems' losses as of the date settlement were approximately \$165 million (approximately \$90 million on the Lehman portfolio, and approximately \$75 million on the ABS portfolio), assessing recoverable damages is more difficult. The State might justifiably have argued that the retirement systems' losses as of June 30, 2009, of more than \$222 million from the investments in Lehman notes and in various ABS were the actual damages. Had those investments not been made or, with Lehman, had they been liquidated months before Lehman's bankruptcy, the retirement systems would have had that \$222 million in cash collateral to reinvest in more appropriate securities. The State might also have argued that from the fall of 2008 until the recoveries described above, the retirement systems was without the use of, and thus unable to reinvest and make earnings on, close to \$400 million that BNYM had invested in Lehman notes and ABS, and that its accounts would have fared considerably better had BNYM complied with the SLA's investment restrictions.

In response, BNYM likely would have objected to the State's attempt to predict what might have occurred had other investments been made by or for the retirement systems. Further,



BNYM presumably would also have objected to all claims for damages and at least argued that any damages would have been far less than those claimed in the complaint.

**iv. Conclusion of the Litigation**

After engaging in settlement negotiations, on May 14, 2013, the State and BNYM entered into a Settlement and Mutual Release Agreement (“Settlement Agreement”) to resolve the dispute between the parties. Pursuant to that Settlement Agreement, the litigation was concluded by a Consent Order of Dismissal with Prejudice filed on May 20, 2013.

It is important to emphasize that, in discussing the claims and defenses raised in the litigation and the potential damages at stake in the litigation, this report does not draw any conclusions regarding the likely outcome in the litigation had it been tried to conclusion. It is simply impossible to predict how the State’s claims would have fared at trial or what amount of damages would have been awarded had the State prevailed on any of its claims.

Finally, solely for reference and background, PEBA has also surveyed the results obtained in other securities lending lawsuits related to losses of cash collateral during the financial crisis of 2008 and 2009. A summary of this survey is attached as Appendix A. However, it should be noted that PEBA believes each of these cases is unique and, while based on similar circumstances, the results of those cases provide no real support for any conclusions relative to the value of the Settlement Agreement in this matter.

**IV. ASSESSMENT OF THE BENEFITS OF THE SETTLEMENT AGREEMENT**

As required by Proviso 105.13 of the 2014-2015 State Budget, PEBA has completed the following review and assessment of the benefits of the Settlement Agreement to the employees and retirees of the State of South Carolina. In completing this review, PEBA makes no assessment of the benefits of the Settlement Agreement as viewed and understood on the date the

agreement was executed. Rather, PEBA has evaluated the benefits of the Settlement Agreement solely from the standpoint of what has been realized to date, as opposed to what could have been realized or what might yet be realized. In particular, as explained in Section IV(D) below, the potential value of the Settlement Agreement could potentially be increased significantly depending upon the resolution of an outstanding issue related to the effect of the agreement upon an asserted deficiency in the retirement systems' collateral reinvestment account in BNYM's securities lending program.

The potential sources of benefits in the Settlement Agreement can be grouped into three categories: the cash payments made by BNYM to the funds held in custody by the Treasurer and to the State's attorneys; the pricing considerations promised by BNYM in connection with the continuation of the custodial banking relationship with the Treasurer; and BNYM's release of claims against the State. Each of these potential sources of benefits will be addressed, in turn, below.

**A. Cash Payments**

**i. Payments to the Collateral Reinvestment Accounts**

Pursuant to Paragraph 1.5 of the Settlement Agreement, BNYM agreed to credit an aggregate amount of \$25 million to the cash collateral accounts in the securities lending program for the funds held in custody by the Treasurer. This \$25 million credit was to be allocated in the following amounts: \$20,039,375.90 into the retirement systems' collateral reinvestment account and \$4,960,624.10 into the State Treasurer Office's collateral reinvestment account.<sup>11</sup> The value

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<sup>11</sup> As noted above, among the other funds held in custody by the State Treasurer are the funds of the State's Retiree Health Insurance Trust Fund and Long-Term Disability Insurance Trust Fund (which are commonly referred to as "other post-employment benefits" or "OPEB" trusts). In the preparation of this Report, and acting as trustees of those funds, PEBA has made inquiries with the Treasurer's office to ascertain the proper accounting of the securities lending gains and losses

of the cash payment to the retirement systems is the face value of the cash payment, namely, \$20,039,375.90.

**ii. Payments to the State's Attorneys**

Under Paragraph 1.6 of the Settlement Agreement, BNYM agreed to pay a sum of \$9 million to the outside counsel that represented the State in the litigation. Paragraph 1.6 further provided that this "negotiated payment [of \$9 million] shall fully and finally satisfy all claims of [the State's] counsel for payment of fees and costs" in the litigation.

PEBA values the payment of these attorneys' fees and costs for the retirement systems' funds by BNYM at approximately \$3,484,520. Under the litigation retention agreement in place between the State and its outside counsel prior to the settlement of the litigation, any recovery in the litigation would be reduced first by the costs and expenses incurred by the State's outside counsel in the litigation, which would be paid to the State's attorneys prior to the calculation of attorneys' fees. After deducting those expenses from any recovery, the State's outside counsel would then receive a contingency fee totaling: 23% of the first \$5 million of the recovery; 19% of the amount between \$5 million and \$10 million; 15% of the amount between \$10 million and \$25 million; and 11% of the amount between \$25 million and \$50 million.<sup>12</sup> Finally, the

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attributable to the OPEB trusts and to determine what portion of the payment under the Settlement Agreement was allocated to those funds. However, to date, the Treasurer's office has not been able to provide the requested accounting and PEBA continues to work with his office to resolve the matter. Because the accounting for the OPEB trust funds has not been provided by the Treasurer's office, PEBA cannot offer comment on the benefit, if any, of the Settlement Agreement for the OPEB funds at this time and will focus this Report solely on the benefits of the Settlement Agreement to the funds of the State's retirement systems.

<sup>12</sup> The retention agreement also provided for a 7% fee on that portion of a settlement or recovery between \$50 million and \$100 million, and a 4% fee on that portion of a settlement or recovery that exceeded \$100 million.

retention agreement also provided that the State Treasurer would retain 10% of the attorneys' fees calculated under this formula.

In this matter, PEBA is advised that the costs and expenses advanced by State's outside counsel were approximately \$500,000.00. And, as discussed throughout this Section of the report, the principal realized value of the Settlement Agreement is the \$25 million cash payment to the funds held in custody by the Treasurer. Based upon those expenses and a total recovery of \$25 million, the original litigation retention agreement would have required payments to the State's outside counsel of approximately \$4,347,500,<sup>13</sup> reducing the net recovery to the funds held in custody by the Treasurer to a total of \$20,652,500. By avoiding that reduction of the \$25 million recovery, BNYM's agreement to pay \$9 million for the fees and expenses for the State's outside counsel represents a value of approximately \$4,347,500 to the funds held by the Treasurer. If allocated on the same basis as the \$25 million payment (i.e., 80.15% to the retirement systems' funds/19.85% to other funds held by the Treasurer), the value of the payment of those attorneys' fees to the State's retirement systems is approximately \$3,484,520.

#### **B. Pricing of Services Consideration**

In Paragraphs 1.1 through 1.4 of the Settlement Agreement, BNYM agreed to provide certain custodial services to the Treasurer at discounted rates in connection with the Treasurer's agreement to engage BNYM to provide custodial services for the funds in his custody for at least another ten years. However, as discussed in detail below, PEBA assigns little value to these pricing discounts.

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<sup>13</sup> This figure represents the total of \$500,000 in expenses deducted from the \$25 million recovery and \$3,847,500 in attorneys' fees equal to 90% of the total contingency fee required by the litigation agreement based upon a \$24,500,000 recovery net of expenses.

**i. Ten-Year Custody Agreement, with Twenty-Percent Fee Discount for Use of HedgeMark Dedicated Managed Accounts**

Under Paragraph 1.1 of the Settlement Agreement, the Treasurer agreed to engage BNYM to provide the Treasurer and the State of South Carolina with custodial services as set forth in BNYM's response to the Treasurer's Request for Proposal for custodial services submitted in January 2012 "for a period of not less than ten (10) years." In response to that continued engagement to provide custodial services, BNYM, in turn, agreed in Paragraph 1.1 that, "if, in connection with such custodial services, the assets under custody in South Carolina's HedgeMark Dedicated Managed Accounts ("HedgeMark") are equal to or greater than \$3 billion, then the Treasurer shall be entitled to an annual credit equal to twenty percent (20%) of BNYM's annual custodial fees." Pursuant to this provision, BNYM and the State Treasurer executed a new Custody Agreement on December 30, 2013, for a ten-year term with two additional one-year renewals.

For various reasons, PEBA assigns no value to this provision of the Settlement Agreement. With regard to the provisions of the custodial contract itself, first, the fee structure is the same as the fees BNYM offered prior to the settlement in its response to the State Treasurer's December 2011 Request for Proposal for custodial and securities lending services. Second, the ten-year term is double the five-year term specified in the Treasurer's solicitation for a new custodial contract. Third, BNYM has refused to provide certain ancillary services under the custody agreement at the quoted rates. For example, after the settlement, PEBA understands that the RSIC attempted to add the Private Investment Support services ("Private i") at the

\$125,000 per year quoted in Exhibit B to the Settlement Agreement, but BNYM refused, responding that those services would cost significantly more than \$125,000.<sup>14</sup>

Further, with regard to the potential fee discounts if more than \$3 billion is placed in HedgeMark Dedicated Managed Accounts, the RSIC has advised PEBA that the HedgeMark Dedicated Managed Accounts offered by BNYM are also of no value to the RSIC. In fact, the RSIC has stated at all times, including at the time of the Settlement Agreement, that it does not intend to use the HedgeMark Dedicated Managed Accounts. Accordingly, to date, the RSIC has not used the HedgeMark Dedicated Managed Accounts and has no plans to do so in the future. Consequently, there can be no expectation that the fee discounts associated with the use of the HedgeMark accounts will be realized, and the potential for any such discounts must be given little value.

In addition, the RSIC has contracted with other providers for a number of the ancillary services for which fees are quoted by BNYM in Exhibit B to the Settlement Agreement and which are offered by BNYM under the new Custody Agreement. The RSIC has advised PEBA that, in selecting service providers for various analytical and reporting needs, it has chosen those that provide the services best suited for the RSIC's needs at pricing that is competitive with that offered by BNYM. Therefore, the pricing schedule for those ancillary services in the agreements with BNYM cannot be assigned any significant value.

**ii. Ten-Year Securities Lending Agreement with a 90/10 Earnings Split**

In Paragraph 1.2 of the Settlement Agreement, the Treasurer also agreed to engage BNYM to provide the Treasurer and the State of South Carolina with securities lending services

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<sup>14</sup> The RSIC had determined that, before the settlement, the Private i services would have had a cost of \$158,000 per year for the retirement systems' then-current direct limited partnerships only, and an approximately \$220,000 per year cost once strategic partnerships were added in. The best cost proposal BNYM offered after the settlement exceeded \$200,000.

under the terms of BNYM's response to the Treasurer's Request for Proposal "for a period of not less than ten (10) years." In connection with that continued securities lending arrangement, BNYM agreed in Paragraph 1.2 to split securities lending revenues with 90% of revenue credited to the funds held by the Treasurer and 10% of revenue retained by BNYM. Pursuant to that provision, the Treasurer and BNYM entered into a new Securities Lending Authorization Agreement on May 7, 2014.

However, as with the new custodial agreement, PEBA assigns little value to the new securities lending arrangement. PEBA does acknowledge that the 90/10 split of securities lending revenues is a reduction in the share of revenues formerly retained by BNYM under the 85/15 split of the prior securities lending agreement. However, under that prior arrangement, BNYM had also agreed to waive fees for its custody services in exchange for its share of earnings from the securities lending program. In contrast, under the new custody and securities lending agreements, BNYM is charging the retirement systems an annual base custody fee of \$260,000.00, with additional asset- and transaction-based charges for foreign transactions. Although PEBA does not yet have a sufficient track-record for the amount of transactional fees that can be expected in addition to the base custody fee to fully analyze the fees charged under the new agreement, it is worth noting that the retirement systems' securities lending account would have to earn in excess of \$5.2 million per year in securities lending revenue in order for the extra five percent of securities lending revenues (i.e., the increase from the 85% share to the 90% share) to exceed the new \$260,000 base custody fee alone. For comparison, the retirement systems only earned \$1.7 million in securities lending revenue in fiscal year 2014 and \$2.5 million in securities lending revenue for fiscal year 2013. Finally, as noted the previous section, the base fee for custody services was already available to the retirement systems before the

Settlement Agreement pursuant to the response submitted by BNYM in connection with the Treasurer's solicitation for a new custody contract.

In addition, the RSIC has made significant changes to its securities lending activities related to the retirement systems' funds that dampen any value to the new securities lending agreement with BNYM. First, for investment policy and risk management reasons, the RSIC has generally reduced its securities lending activities as a whole. Second, the RSIC has selected Deutsche Bank to also serve as a securities lending agent for the retirement systems' funds, although it is now completing due diligence and finalizing the contract, and thus has not yet begun utilizing its services. The RSIC has advised PEBA that the earnings split with Deutsche Bank will also be 90/10. If the RSIC later chooses to expand its securities lending activities, it may elect to do so with Deutsche Bank.

For all of the foregoing reasons, PEBA assigns no value to the new securities lending agreement as part of the Settlement Agreement.

**iii. HedgeMark Platform Services at a Twenty-Percent Fee Discount**

Under Paragraph 1.3 of the Settlement Agreement, the State Treasurer agreed to contract with HedgeMark Platform Services "for a period of not less than ten (10) years," which BNYM agreed to offer at a discounted rate equal to eighty percent of the usual fee. PEBA assigns no value to the employees and retirees of the State from the terms of this provision. As discussed above, the RSIC has not used, and at no time has had plans to use, the HedgeMark products offered by BNYM, including the HedgeMark Platform Services. Consequently, obtaining those services at a discounted rate cannot be expected to provide any value to the retirement systems' funds.



**iv. Annual Credit of \$150,000 for Training**

In Paragraph 1.4 of the Settlement Agreement, BNYM agrees to provide the State Treasurer with an annual credit of \$150,000, for at least ten years, to be used for the training of staff and employees of the Treasurer's office, the RSIC, and PEBA. PEBA also assigns little or no value to this credit for additional training. Not only is the amount of the training credit modest, but the training itself is supplemental to that included as part of the custody agreement and would primarily relate to the various ancillary services offered by BNYM and to the use of the HedgeMark Platform. Because the RSIC does not utilize most of the ancillary services offered by BNYM or the HedgeMark Platform, this additional training credit offers little value to the retirement systems.

**C. Release of Claims by BNYM**

Pursuant to Paragraphs 2.1 through 2.4 of the Settlement Agreement, BNYM and the State provided each other a mutual release of claims. In particular, with regard to BNYM's release of claims against the State and the scope of that release, Paragraphs 2.2 and 2.3 of the Settlement Agreement provide as follows:

- 2.2 Upon execution of this Agreement, BNYM Parties, do hereby release and forever discharge the South Carolina Parties, from any and all actions, causes of action, suits at law or in equity, complaints, proceedings, claims, counterclaims, crossclaims, obligations, demands, dues, debts, damages, liabilities, liens, costs, and expenses (including, without limitation, attorneys' fees), whether asserted or unasserted, whether known or unknown, whether due or to become due, and of any kind or nature, in law, equity, or otherwise, arising directly or indirectly out of, relating to, or in any other way involving in any manner whatsoever, the SLA, Complaint or the Litigation, and all claims arising under federal, state, or local laws relating thereto, provided, however, notwithstanding anything to the contrary set forth herein, that this release shall not extend to any obligation assumed under this Agreement by any Party hereto.
- 2.3. In connection with the waiver and release of claims set forth in this Agreement, each Party acknowledges that it is aware that it may discover facts in addition to or different from those that it may now know or believe to be true with respect to

the subject matter hereof. Nonetheless, it is the intention of each Party to hereby fully, finally, and forever, settle and release all of the claims as set forth in Paragraphs 2.1 and 2.2 herein and that, in furtherance of such intention, the waiver and releases given herein will be and remain full and complete releases notwithstanding the discovery or existence of any such additional or different facts.

At the time of the execution of the Settlement Agreement in May 2013, the retirement systems' cash collateral reinvestment account in BNYM's securities lending program reflected a deficiency of approximately \$90 million. Subsequently, in April 2014, PEBA was advised by the State Treasurer that BNYM had demanded that PEBA approve payment to BNYM of sufficient funds to cover the remaining deficiency in the cash collateral reinvestment account in BNYM's securities lending program for the retirement systems' funds, in an amount of approximately \$49 million. After consideration of the demand by the PEBA Board of Directors, PEBA wrote to the Treasurer's office on May 1, 2014, to request "citations to the contract provisions or other legal sources of authority that establish that the retirement trust fund currently owes BNYM \$49 million to cover a collateral deficit in the securities lending program." In the letter, PEBA further informed the Treasurer's office that it could not authorize payment to BNYM until it had received satisfactory clarification of the legal basis for the retirement systems' liability to pay the demanded amount. To date, PEBA has not received a response from the Treasurer's office or BNYM explaining the legal basis for the demanded payment from the retirement systems' funds.

Until this information is received, PEBA cannot evaluate the full value of the Settlement Agreement. If any deficiencies in the cash collateral reinvestment accounts are obligations or debts that the retirement systems owed to BNYM itself under the securities lending agreement, it may be that BNYM released any claim for payment of those obligations under the release provisions of the Settlement Agreement. In such case, the retirement systems would be relieved

of any obligation to pay not only the demanded \$49 million by BNYM in April 2014, but also the full \$90 million deficiency at the time of the settlement. And, accordingly, the value of the Settlement Agreement to the retirement systems would be increased by the amount of any deficiency released by BNYM. However, if the release provisions are shown not to release the deficiency in the cash collateral reinvestment account and the retirement systems remains obligated to pay funds to cover that deficiency, the release provisions of the Settlement Agreement will not represent a significant benefit to the retirement systems. Until this issue, which is potentially of great significance and complexity, is resolved, PEBA will be unable to place a final value on the release provisions of the Settlement Agreement. Further, because this issue remains unresolved as of the date of this Report, PEBA has refrained from providing additional comment in the Report regarding the merits of the various arguments that could be put forth in a dispute regarding the application of the release provisions to the securities lending deficiency and refrained from attempting to predict the outcome of any such dispute.

## V. CONCLUSION

Having thoroughly reviewed this matter, PEBA has concluded that the benefit of the Settlement Agreement to the employees and retirees of the State of South Carolina consists principally of the cash payments made by BNYM to the cash collateral reinvestment account for the State's retirement systems and BNYM's payment of legal fees to the State's outside counsel. The total value of these payments, as allocated to the retirement systems' funds, is approximately \$23,523,895.90, which represents the total of the \$20,039,375.90 credited to the retirement systems' securities lending account and \$3,484,520 in attorneys' fees that would have been payable from the funds payable to the retirement systems if not for BNYM's agreement to pay \$9 million in attorneys' fees to the State's outside counsel. With regard to various pricing

considerations related to the Treasurer's agreement to engage BNYM to provide continued custodial and securities lending services for a ten-year period, PEBA assigns little value to those pricing considerations, as most of those services and fees were already offered to the Treasurer by BNYM during the public solicitation for a new custodial contract and a number of other services, including those associated with the HedgeMark products, are of no interest to the RSIC or PEBA. Finally, if the release provisions of the Settlement Agreement relieve the retirement systems of any obligation to pay funds to cover the remaining deficiency in the cash collateral reinvestment account, the value of the Settlement Agreement would be materially enhanced. However, as that question remains unresolved at this point, PEBA cannot assign a value to the release provisions of the Settlement Agreement as of the date of this Report.

## APPENDIX A

### Survey of Securities Lending Cases

The State of South Carolina and its retirement systems were certainly not the only entities to suffer losses during 2008 and 2009 from investments in Lehman notes, investments in asset-backed securities ("ABS"), or from investments in similar securities that allegedly did not conform to the guidelines governing a securities lending and collateral reinvestment program. A number of states and large pension plans have asserted claims of this type against BNYM and other banks and financial institutions who engaged in securities lending and collateral reinvestment activities. Some of those cases are not yet resolved; many were settled without litigation being filed or during the course of litigation; and some were dismissed or resulted in a defense verdict with no recovery. In the majority of the cases involving BNYM, the settlement included an agreement that the plaintiff remain a client of BNYM for custodian services and securities lending activities. In that regard, the settlement by the State Treasurer and the Attorney General is consistent with most other settlements obtained from BNYM.

#### **I. Cases Tried to Verdict**

##### *A. The London case*

Although PEBA does not claim to have done an exhaustive search of every claim similar to the action brought by the State, it located only one action that went to trial and resulted in a verdict in favor of the plaintiff. That case involved a Swedish pension fund, AP1, who sued BNYM for alleged losses of \$33.7 million arising from BNYM's investment of securities lending collateral in medium-term notes issued by Sigma Finance, a structured investment vehicle. A judge, sitting without a jury, determined that BNYM was liable to AP1, but not because BNYM had invested in the Sigma Finance notes. Instead, the judge found that BNYM

knew the risk of default by Sigma a number of months before the actual default and had advised some clients of that risk, but failed to provide that information to AP1 when it discussed with AP1 strategies for handling its Sigma investment. The opinion included a number of rulings adverse to AP1: the judge rejected the arguments that investing in the Sigma medium term notes was an inappropriate investment; that BNYM should have sold the notes before Sigma failed; that BNYM owed fiduciary duties to AP1; and that BNYM failed to monitor the Sigma notes properly as credit markets deteriorated. The judge also noted that had the Sigma notes been sold before Sigma defaulted, AP1 would have suffered significant losses, though not nearly as large as after Sigma's default.

PEBA has been unable to determine what damages were ultimately awarded by the London court (the liability opinion makes no mention of a damages award), or whether the matter was settled after the decision on liability. PEBA notes that in South Carolina's action, the State may not have had the benefit of evidence similar to evidence of the discussions between BNYM and AP1 regarding the merits of retaining the Sigma securities, or of BNYM's discussions with other clients about Sigma. Differences between South Carolina law and the law of Great Britain or the EU may also distinguish the AP1 outcome from other actions of a similar nature.

*B. The Minnesota Blue Cross case*

Perhaps the best example of a contrary outcome is found in Blue Cross and Blue Shield of Minnesota et al. v. Wells Fargo Bank, N.A., an action filed and tried to a jury in the United States District Court in Minnesota. The action was filed on behalf of ten plaintiffs, each of whom was an administrator of a retirement, pension, or benefit plan. Each of the plaintiffs participated in a securities lending and collateral reinvestment program, and each agreed that the

collateral reinvestments could be made through certain business trusts formed by Wells Fargo. Substantially all of the securities acquired through the trusts were issued by Cheyne Finance, Stanfield Victoria, and Lehman Brothers. The claims made were very similar to those made in the State's action, namely, that the Cheyne portfolio inappropriately contained a significant amount of subprime real estate asset-backed securities, and that Wells Fargo knew or should have known and warned about the impending demise of Lehman Brothers.

The jury returned a verdict in favor of Wells Fargo, denying any relief to the plaintiffs on any of the various counts of their complaint. Subsequent motions by the plaintiffs for judgment notwithstanding the verdict, for a new trial, or for a judgment on certain of the claims that were not submitted to the jury were denied. Accordingly, in a case with some very similar facts as South Carolina's action, a jury rejected any recovery for the ten plaintiffs (and thus for the employees and retirees with interests in those plans).<sup>1</sup>

## II. Cases Settled

There have been numerous settlements, and PEBA does not attempt to describe them all. The following appear to be the most relevant in comparing the relative value of the settlement of South Carolina's action.

### A. *The New York JPMorgan Case*

In an action titled, Board of Trustees of the AFTRA Retirement Fund et al. v. JPMorgan Chase Bank, N.A., in the United States District Court for the Southern District of New York, the plaintiffs represented a class comprised of all of JPMorgan Chase Bank's securities lending customers invested in Sigma Finance notes. While the action was settled for \$150 million,

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<sup>1</sup> There were several similar actions that were dismissed before trial. Because those cases may have involved defects in the pleadings of the claims (and in some, the plaintiffs were permitted to re-file amended complaints), PEBA has assigned less importance to them.

several things distinguish it from the South Carolina action: (1) the damages claimed by the collective class were claimed to exceed \$500 million; (2) JPMorgan had provided repurchase financing to Sigma; and (3), in September, 2008, when Sigma failed to meet a JPMorgan margin call, JPMorgan declared Sigma in default, seized assets that had been pledged, and forced Sigma into receivership. In the South Carolina action, the State had no evidence that BNYM took the actions that caused or contributed to Lehman's bankruptcy or the financial difficulties of any of the ABS issuers.

*B. The State of Florida Settlement*

In late 2013, the Florida Attorney General settled claims on behalf of Florida's retirement system for \$28 million, plus a \$500,000 per year deduction from its custodian fees for a period of ten years. Although that case also involved allegations of improper investments in Sigma Finance medium-term notes, that issue was collateral to claims of the State of Florida that BNYM had overcharged the state retirement system for foreign currency and securities transactions.

*C. The Unsuccessful Southern California IBEW-NECA Action against BNYM*

In its survey of settlements, PEBA determined that the actual settlement proceeds obtained, as a percentage of total losses claimed, varied widely from case to case. For example, in The Board of Trustees of the Southern California IBEW-NECA Defined Contribution Plan et al. v. The Bank of New York Mellon Corporation, a case filed in the United States District Court for the Southern District of New York, all claims related to BNYM's purchase of Lehman Brothers notes in the plaintiff's securities lending accounts. Four years after the case was filed, it settled for \$630,000, the same amount BNYM had offered before the plaintiffs filed suit. PEBA has been unable to determine the total damages claimed by that plaintiff, but from court filings, it



did determine that the attorneys' fees sought by plaintiff's counsel exceeded the settlement by several million dollars.

*D. The State of Pennsylvania BNYM Settlements*

Through a series of actions on behalf of retirement systems in the State of Pennsylvania, all based upon investments made in medium-term notes issued by Sigma Finance, BNYM paid \$19 million to settle the litigation, and repaid \$22 million in previously collected fees. The \$41 million in total recovery represented just more than 32% of the net loss suffered by the retirement systems and the state's treasury from its investments in Sigma.

*E. The Oklahoma Class Action against BNYM*

In a class action suit against BNYM in the United States District Court in Oklahoma, the plaintiff obtained a settlement of \$280 million. From notices to class members, PEBA has determined that, for foreign members of the class, the recovery represented 11% of their net losses relating to investments in the medium-term notes of Sigma Finance, and for domestic-based class members, it represented 35% of their total net losses. It has been reported by analysts that the settlement ultimately was approximately 28% of the total net losses.