CORPORATE ACTIONS:
THE CASE OF THE MISSING BILLIONS

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Introduction

The Problem

The problem is massive. It is not a potential problem. It is a problem that is happening now. Asset managers are failing to optimize corporate action decisions on a global scale, which has resulted, and is continuing to result, in significant losses to beneficial owners. We estimate these losses in Section I of this White Paper. The data show, in scrip dividends alone, aggregate losses to beneficial owners that exceed a billion dollars a year. Aggregate losses to beneficial owners resulting from undersubscribed rights offerings, likewise, exceed a hundred million dollars a year. The losses are compounding each and every day.

The problem is a problem only if it is ignored. There is no reason that asset managers (or the custodians that act on their behalf) should not have systems in place that value corporate action determinations on the election date, and that process corporate action determinations such that the full value of the optimal election is captured for the beneficial owner. These are critical functions that have been neglected by a sizable cross-section of asset managers. This neglect has taken different forms. Some asset managers optimize corporate action decisions in some names or positions, but not others. Other do not attempt to optimize at all, and simply default.

We believe there are serious legal risks for asset manager fiduciaries that systematically fail to optimize corporate action decisions. These legal risks fall into two general categories, regulatory and litigation.

The Regulatory Risks

We discuss regulatory risks in Section II of this White Paper. The regulatory trend is clear. Regulators are demanding increased transparency in the context of corporate actions. Indeed, as part of MiFID II, the European Securities Markets Authority has already begun to require the reporting of some corporate action determinations. Similar initiatives are percolating in other jurisdictions. The path here is familiar. Increased transparency means increased regulatory scrutiny. Increased regulatory scrutiny means—inevitably and unfortunately—increased regulatory investigations and enforcement.

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The Litigation Risks

We discuss litigation risks in Section III of this White Paper. Increased regulatory transparency raises not only the prospect of regulatory investigations and enforcement, but also the prospect of lawsuits and civil liability. Asset managers are held to the highest of fiduciary standards. Under the relevant jurisprudence, asset managers have a fiduciary obligation to maximize the value of corporate action determinations for their beneficial owners. We think that courts are especially likely to uphold these fiduciary obligations where, as here, some of these fiduciaries are knowingly and systematically failing to recover the full value of corporate action events that are the undisputed property of their investors.

Potential Solutions

We discuss potential solutions in Section IV of this White Paper. The solution for asset managers (or the custodians acting on their behalf) is simple: put in place systems that value corporate action determinations on the election date, and that process corporate action determinations such that the full value of the optimal election is captured for the beneficial owners. There are various ways, however, to get there. Some custodians or asset managers will decide that they are equipped to implement such systems themselves, and can satisfy their fiduciary obligations without the help of an outside firm. Others will decide that their internal resources are best devoted to core custodial or advisory functions, and to engage an outside firm. Either choice may be optimal, depending on the characteristics of the institution.

Section I

Missed Value from Corporate Actions that Require Elections

Asset managers frequently need to take action with regard to corporate events such as scrip dividends, rights offerings, and tender offers. In the typical corporate event that requires an election, there is a deadline by which investors need to elect whether to participate, or whether to receive cash or shares. In some cases, such as in scrip dividends, the optimal election is straightforward for sophisticated financial professionals, provided such financial professional devote a minimal amount of attention.

We analyze how much value is missed by investors, including by some of the largest asset managers in a dataset comprised of all scrip dividends globally between 2011 and 2017.[1]

[1] The asset manager sample was compiled from anonymous data provided by Scorpeo. The data relate to shareholdings and election positions of a group of 17 asset managers ("The Asset Managers"). The sample, which covers the years 2011 to 2017, does not cover all of the holdings of all of the Asset Managers in scrip dividends ("The Sample"). For some of the Asset Managers, data were only available for a portion of that period. The global list of scrip dividends was provided by Scorpeo. Scorpeo is a corporate actions data and technology company and offers a product that tracks scrip dividends and captures missed value from suboptimal elections on behalf of asset managers.

While scrip dividends are not everyday events, the total amounts involved are large. There are around 200 scrip dividends every year worldwide, and the amount distributed in scrip dividends reaches around \$70 to \$80 billion annually. Rights offerings and other corporate actions that require elections add significantly to this number. Investments by U.S.-based custodians and asset managers in the companies that offer scrip dividends exceed similar investments by custodians and asset managers from other regions of the world.

Table I: Number of Scrip Dividends

Year	Number of Scrip Dividends	Total Distribution (Billion US$)
2011	171	58.5
2012	201	70.8
2013	199	70.2
2014	237	77.9
2015	238	75.9
2016	218	80.7
2017	196	77.3
Total 2011-2017	**1,460**	**$511.2**

We find that investors frequently make the suboptimal election in scrip dividends. In 38% of scrip dividends, the majority of shares are elected in a suboptimal manner (Table II). Investors display a propensity to receive cash even when it is suboptimal, such that approximately three-quarters of the suboptimal elections market-wide are in favor of cash over shares. Because electing cash is typically the default, and because investors are required to take an affirmative step to elect shares, this outcome may result in part from investors' inattentiveness in tracking scrip dividends and inertia in taking optimal action.

Table II: The Number of Scrip Dividends for Which the Majority of Shares were Elected Suboptimally

Optimal Election	Global		The Asset Managers in The Sample	
	Number of Events Majority was Suboptimal	*% of Events Majority was Suboptimal*	Number of Events The Asset Managers Were Suboptimal	*% of Events The Asset Managers Were Suboptimal*
Cash	146	*10%*	114	*2%*
Stock	410	*28%*	3,322	*54%*
Total Suboptimal	556	*38%*	3,436	*56%*
Total Events	**1,460**	***100%***	**6,124**	***100%***

We also obtain The Sample from The Asset Managers, and we analyze the elections made by these managers. The Asset Managers had investments in companies that had a total of 6,124 scrip dividend events. We find that The Asset Managers make the wrong election at an even higher rate than the average investor, at 56%. Value is more often missed when the optimal selection is stock. One likely reason for The Asset Managers to make suboptimal elections more frequently than the average investor may be that they give standing orders to their custodians to elect cash—whether or not optimal.

The mechanics of the optimal election:

On or before the ex-dividend date, issuers typically announce the cash payment and the new shares to be received for each share held. Then, shareholders are expected to elect whether they would like to receive cash or shares on a certain date referred to as the election date—typically three weeks after the ex-dividend date. The scrip dividend to be paid is often derived from the market prices between the ex-date and the election date.

The question facing the investors in a scrip dividend offer is simple: Is the scrip dividend at the closing price on the election date worth more or less than the cash dividend? After all, it is straightforward to sell the shares for cash, if the investor has a preference for cash and the scrip shares are worth more than the cash dividend amount. If the investor is worried about unfavorable price movements between the election and the payment dates, then it is also possible to lock in the share price upon election.

The dollar amount of missed value from suboptimal elections in scrip dividends is large, consistent with the percentage of suboptimal elections that we observe. On average, around $1.3 billion is missed by investors each year. This is all the more puzzling because optimal decision-making in scrip dividends is straightforward and scrip dividends are highly predictable once initiated.[2]

Table III below summarizes the scrip dividend activity around the world between 2011 and 2017. By simply taking the difference between the cash amount and the value of the scrip shares at the closing price on the election date, we arrive at a large figure for how much investors forego every year in scrip dividends.[3] In recent years, investors have missed between $1 billion and $1.5 billion per year in scrip dividends. Between 2011 and 2017, we estimate that a total of around $8.9 billion was missed by not making the optimal election.[4]

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[2] H. Bessembinder & F. Zhang, *Predictable Corporate Distribution and Stock Returns*, 28 REVIEW OF FIN. STUDIES (forthcoming Apr. 2015), at 10, finds that the same firm announcing a stock dividend in the same month in the subsequent year is 79 times as high as the average firm (29.2% vs. 0.37%).

[3] We have conservatively assumed, for purposes of this analysis, that the withholding tax is zero on cash dividends. If withholding tax is taken into account, however, the missed value from suboptimally selecting cash over shares is likely to be higher than the average $1.3 billion per year we find between 2011 and 2017.

[4] The missed value is, in effect, a transfer of wealth from one group of shareholders (who made the suboptimal election) to another group of shareholders (who made the optimal election).

Table III: Value Missed in Scrip Dividends Globally by All Investors and by The Asset Managers in The Sample

Year	Global Missed Value (Million US$)	Missed Value by The Asset Managers (Million US$)
2011	1,018	95.0
2012	1,598	100.4
2013	823	115.9
2014	1,182	119.1
2015	1,591	122.2
2016	1,547	162.2
2017	1,184	188.0
Total 2011-2017	**$8,943**	**$902.9**

Recall from Table I that around $70 to $80 billion a year has been distributed from dividends electable in cash or scrip shares since 2011. Thus, investors have missed around 1.5 to 2% of the dividends distributed. Moreover, this value is not missed by retail investors alone. Asset managers who are paid to generate value for investors as fiduciaries are among those who missed this value. Among The Asset Managers, $188 million out of the $1.184 billion in total value in The Sample was missed in 2017.

The Asset Managers include some of the largest asset managers in the world. While most scrip dividends are paid by non-U.S. companies, the global investments by U.S. asset managers in scrip paying companies exceed those of non-US asset managers in our sample. Given the scale and sophistication of these institutions, the $188 million value missed in 2017 and the $903 million total value missed between 2011 and 2017 is significant. The missed values stand to add around 10 basis points to the annual returns of the portfolios of scrip-paying securities.

Table IV: Value Missed in Scrip Dividends Globally Due to Suboptimal Elections by the Average Investor Compared to The Asset Managers in The Sample–As a Percentage of Total Value of Scrip Dividend Paid

Year	Global Missed Value (% of Total Dividend)	Missed Value by The Asset Managers (% of Total Dividend)
2011	1.7%	3.1%
2012	2.3%	2.6%
2013	1.2%	3.0%
2014	1.5%	3.0%
2015	2.1%	3.1%
2016	1.9%	2.9%
2017	1.5%	1.8%
Total 2011-2017	**1.7%**	**2.6%**

Further probing why asset managers miss value, we compare the percentage of the dividend missed. Asset managers tend to miss a greater percentage of the dividends offered by their investments. The most likely reason in our view is that asset managers do not believe it is worth the effort to keep track of scrip dividends and, as a result, they give standing orders to their custodians to choose cash. However, they miss a large value from the elections and it is unlikely that the cost savings outweigh the missed value, which exceeds $100 million per year among The Asset Managers in The Sample.

We also probe whether the missed value is different across jurisdictions. If local institutional differences play a role in taking the optimal action, we expect to see variability in missed value across jurisdictions. However, we do not find significant variation. We report below our country-level analysis aggregated at the regional level for the United Kingdom, continental Europe, and the rest of the world.

Table V: Value Missed in Scrip Dividends in Different Regions of the World Due to Suboptimal Elections by the Average Investor Compared to The Asset Managers in The Sample– As a Percentage of Total Value of Scrip Dividend Paid

		Global		The Asset Managers	
Region	**Optimal Election**	**No. Companies**	**Missed Value (% of Total Dividend)**	**No. Companies**	**Missed Value (% of Total Dividend)**
EU	Cash		2.60%		0.21%
EU	Stock		2.46%		7.01%
EU	Total	124	2.51%	95	4.48%
UK	Cash		0.52%		0.10%
UK	Stock		1.80%		2.90%
UK	Total	50	1.19%	50	1.72%
ROW*	Cash		0.94%		0.02%
ROW	Stock		1.86%		3.89%
ROW	Total	81	1.54%	69	2.44%
Total 2011-2017		**255**	**1.75%**	**214**	**2.59%**

* "ROW" or "rest of the world" includes South Africa, Hong Kong and Singapore.

In most scrip dividend elections, the default choice for investors who do not respond is receiving cash. Therefore, we also investigate more closely whether the missed value varies when the optimal election is cash or shares. The following table shows the missed value by the type of optimal election, cash or shares.

Table VI: Value Missed as a Percentage of Total Distribution in Events Where Electing Cash vs. Shares was the Optimal Election

Optimal Election	Global	The Asset Managers in The Sample
Cash	1.26%	0.12%
Stock	2.09%	4.25%
Overall	**1.75%**	**2.59%**

We see that both the average investor and asset managers miss more of the distributed value when the optimal election is stock. The tendency to forego more value when the optimal election is not the default (*i.e.* shares) suggests that a big part of the missed value may result from investors' inattention.

Percentage of the total distribution missed by asset managers is primarily due to what we think are standing orders to elect cash. This suggests that investment managers can benefit significantly from being attentive and identifying situations where the optimal election is scrip shares. In our rough estimation, investment managers can add around 10 basis points to their annual returns from investments that offer scrip dividends.

The \$8.9 billion of aggregate value missed by investors between 2011 and 2017 is a large amount. We note that if the funds were able to recover a substantial amount of this missed value—after taking into account the costs of doing so—their returns might be substantially enhanced.

Rights Offerings

Rights offerings represent another corporate election in which investors often miss value. There were fewer rights offerings than scrip dividends between 2011 and 2016—40 per year, on average—but the missed value was far larger, on average. The capital being raised was approximately \$485 billion, but the average participation by shareholders was 92.92%. Approximately \$662 million was missed in these undersubscribed rights offerings.

It is easy to see that even though the number of rights offerings are fewer than scrip dividends, the amount of missed value is far higher per offering. If one were to include other types of corporate event elections beyond scrip dividends and rights offerings, the potential impact would be even higher.

Our high-level analysis shows the importance of missed value from corporate elections. Fiduciaries of investor assets need to take a fresh look at the value they can capture from these elections and see the potential impact on improved portfolio returns and the improvements for pension fund deficits. As of the end of 2016, unfunded liabilities of private-sector defined benefit pension plans in the U.S. alone stood at $0.5 trillion.[5] The approximately 10-basis point per year improvement that these asset managers would derive from recovering missed value from scrip dividends alone, over the seven years we have analyzed, would add over 1% to the returns of portfolios of companies that offer scrip dividends. This would make a meaningful contribution to pension deficit reduction.

Section II

The Regulatory Risks to Asset Managers that Fail to Maximize the Value of Corporate Action Determinations

Regulators have begun to require the reporting of corporate action determinations made by market participants. On October 10, 2016, the European Securities and Markets Authority ("ESMA") released its Final Report,[6] and its Guidelines on Transaction Reporting,[7] as part of MiFID II. These new ESMA requirements mandate the reporting of transactions resulting from corporate actions involving "some discretion by the investor."[8] Not all transactions resulting from corporate action determinations are reportable, but many are. Reportable transactions generally include those resulting from elections of stock, whether by election or default.[9]

We expect regulators in other jurisdictions to follow suit, including the Securities and Exchange Commission (the "SEC"). Indeed, the SEC has already done so in the analogous context of shareholder proxy voting. Specifically, the SEC has mandated that mutual funds make annual disclosures concerning shareholder proxy voting.[10] The purpose of this increased transparency is to allow mutual fund investors the ability to determine whether voting decisions made by mutual fund advisers are aligned with their own interests, and to ensure that mutual fund advisers are not voting to curry favor with portfolio companies.[11] This same logic applies with equal force to corporate action determinations. Increased transparency of corporate action elections enables

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[5] Investment Company Institute, INVESTMENT COMPANY FACT BOOK 137 (57th ed. 2017).

[6] European Securities and Markets Authority, FINAL REPORT: GUIDELINES ON TRANSACTION REPORTING, ORDER RECORD KEEPING AND CLOCK SYNCHRONISATION UNDER MIFID II (Oct. 10, 2016), *available at* www.esma.europa.eu/sites/default/files/library/2016-1451_final_report_on_guidelines_mifid_ii_transaction_reporting.pdf (the "Final Report").

[7] Securities and Markets Authority, GUIDELINES: TRANSACTION REPORTING, ORDER RECORD KEEPING AND CLOCK SYNCHRONISATION UNDER MIFID II (Oct. 10, 2016) (corrected July 8, 2017), *available at* https://www.esma.europa.eu/sites/default/files/library/2016-1452_guidelines_mifid_ii_transaction_reporting.pdf (the "Guidelines on Transaction Reporting").

[8] *Id*. at 10.

[9] In the context of scrip dividends, the Final Report and Guidelines on Transaction Reporting were broadly interpreted to mean that when a market participant elects stock, the election of stock is reportable on the corporate action delivery date. In subsequent guidance, ESMA clarified that when a market participant receives stock by default, the receipt of stock is reportable on the corporate action delivery date. Conversely, when a market participant receives cash by default, there is no reportable transaction. *See* European Securities and Markets Authority, QUESTIONS AND ANSWERS ON MIFIR DATA REPORTING 55 (Sept. 26, 2018), *available at* https://www.esma.europa.eu/system/files_force/library/esma70-1861941480-56_qas_mifir_data_reporting.pdf.

[10] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Exchange Act Rel. No. 33-8188 (Jan. 31, 2003), *available at* www.sec.gov/rules/final/33-8188.htm.

[11] *Id.*

beneficial owners to ensure that corporate action determinations are aligned with their own economic interests, and to ensure that they are not made (by default or otherwise) for the benefit of custodians and asset managers. In both contexts, increased transparency is essential for aligning the interests of the fiduciary with those of its beneficiaries.

Regulatory initiatives have not been limited to increased transparency, but have also included a focus on the compliance programs of registered investment advisers. The SEC has made clear that it will scrutinize the compliance programs of registered investment advisers to ensure that they have sufficient policies and procedures in place to identify, monitor and value corporate actions. Specifically, in May of 2006, the SEC issued guidance to registered investment advisers on issues to address in their compliance programs.[12] The SEC's guidance stressed, among other things, that compliance programs should be designed to ensure that corporate actions are "independently monitor[ed]," and are "timely and accurately capture[d]."[13]

Increased regulatory transparency—whether in the form of increased reporting or increased compliance scrutiny—leads inevitably to increased regulatory investigations and enforcement. The path is familiar. As regulators collect more corporate action information, and increase their scrutiny of the compliance programs of advisers, more investigations are referred and commenced, and more enforcement cases are brought. This is especially true where, as here, the relevant data raise serious concerns. As discussed above, the relevant data show aggregate losses exceeding a billion dollars a year in scrip dividends alone.

Nor should asset managers avoid responsibility. Asset managers owe fiduciary obligations to beneficial owners. Some have systematically failed to optimize corporate action determinations; others have sporadically failed to optimize corporate action determinations. The resulting aggregate losses are significant. We believe it is only a matter of time before regulators bring investigations and enforcement cases.

This has already happened in contexts that we believe to be analogous. In the stock loan context, for example, Voya Investments LLC and Directed Services LLC (collectively, "Voya") agreed to settle an SEC investigation for $3.6 million in March of 2018.[14] Like many investment advisers, Voya engaged in stock lending activities purportedly to generate additional income for its mutual fund investors. The SEC found, however, that Voya's stock loan recall practices favored the interests of its affiliates, not the mutual fund investors to whom it owed fiduciary duties. Just before the record date, Voya would recall loaned securities so that its insurance company affiliates could take advantage of a tax benefit as the record shareholder. The mutual fund investors, as a result, received less stock loan income and no offsetting tax benefit. The lesson here is simple. Investment advisers cannot, according to the SEC, engage in stock lending practices that "place the interests of their affiliates over those of clients."[15]

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[12] *Questions Advisors Should Ask While Establishing or Reviewing Their Compliance Programs* (May 2006), *available at* www.sec.gov/info/cco/adviser_compliance_questions.htm.
[13] *Id*.
[14] *See* Press Release, *Voya Advisors Agree to Repay Clients and Settle Charges that They Failed to Disclose Securities Lending Conflict* (Mar. 8. 2018), *available at* www.sec.gov/news/press-release/2018-35.
[15] *Id.*

In the context of corporate actions, we believe that the risk of regulatory enforcement is substantially higher. Asset managers that engage in securities lending are seeking *additional income* for the benefit of their beneficial owners, and they do so by taking on *additional risk*. That additional income is not property that must be captured for beneficial owners. Indeed, where the activities are discretionary, and involve some amount of risk, custodians and asset managers have no obligation to maximize, and should exercise their discretion cautiously. Under the circumstances, regulators have been justifiably deferential, provided the asset manager fiduciary does not (as Voya did) puts its own interests ahead of the interests of its investor beneficiaries.

Asset managers that fail to optimize corporate actions, in contrast, are entitled to no such regulatory deference. They are not seeking additional income. They are not taking on additional risk. They are simply failing to recover the full and available value of a corporate action event. This distinction is critical. Beneficial owners may or may not receive additional income from securities lending, but there is no question they are entitled to receive the full and complete value of a corporate action event. It is the property of the beneficial owner. The breach is the failure to recover that which beneficial owners are indisputably entitled.

For all these reasons, we think it is highly likely that regulators will pursue investigations and, ultimately, bring enforcement cases against asset managers that knowingly and repeatedly fail to recover the full and available value of corporate action events.

Section III

The Legal Risks to Asset Managers that Fail to Maximize the Value of Corporate Action Determinations

Asset managers owe fiduciary duties to their beneficial owners. Fiduciary duties are among the highest obligations imposed in our law, and include the duties of care and loyalty. Fundamental to the duty of care is the obligation to seek to maximize the value of the property of the beneficiaries, or the value of any potential recovery to which the beneficiaries are entitled.[16]

The seminal Delaware case, *In re Caremark Int'l Inc. Derivative Litigation*,[17] elaborates on the duty of care that applies to corporate fiduciaries. *Caremark* held that a fiduciary must employ information and reporting systems that are "in concept and design adequate to assure… that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."[18] The failure to implement such information and reporting systems, the court held, may render the fiduciary "liable for losses caused by non-compliance with applicable legal standards."[19]

[16] *See, e.g., In re Quintus Securities Litigation*, 148 F.Supp. 2d 967, 971 (N.D. Cal. 2001); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).
[17] 698 A.2d 959 (Del. Ch. 1996) ("*Caremark*").
[18] *Id*. at 970.
[19] *Id.*

These principles apply equally to asset manager fiduciaries. Asset manager fiduciaries (or the custodians acting on their behalf) must have monitoring systems in place to ensure that they comply with their obligations to collect property to which their beneficiaries are entitled. The failure to satisfy this obligation, unfortunately, is not new. Indeed, this very issue has come up in the recent past. As was documented extensively in the research of Professors Cox and Thomas,[20] custodian and asset manager fiduciaries had systematically failed to identify and file claims in securities class actions, and had, as a result, failed to capture substantial amounts of available settlement recovery. The aggregate losses were, in fact, remarkably close to the aggregate losses for scrip dividends calculated in Section I of this White Paper.[21]

Professors Cox and Thomas concluded, predictably, that *Caremark* and its progeny impose onerous fiduciary duties on the trustees of institutional investors. Pursuant to these onerous fiduciary duties, trustees of institutional investors must ensure that they have adequate information and reporting systems in place to identify and process claims for recovery in securities class action settlements.[22] According to the professors:

> "[W]e believe that institutional investors have a legal duty to file claims in securities fraud class action settlements. There is amazing uniformity about the fiduciary obligations of institutional investors to their investors in this area: these institutions cannot abandon without reason a claim to recover funds in a securities class action settlement."[23]

Professors Cox and Thomas issued a clear warning: "[t]rustees at funds without claims filing systems, or with systems suffering from systematic failures, who do not act to address their problems face a threat of potential liability for the amount of money that they left on the table."[24] The professors were not wrong. A wave of litigation followed, including more than 40 separate

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[20] *See* James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?,* 80 WASH. U.L.Q. 855 (2002) ("*Cox & Thomas I*"); James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STANFORD L. REV., 411 (2005) ("*Cox & Thomas II*").
[21] *See Cox & Thomas II*, at 412 (estimating that "each year slightly more than $1 billion is left on the settlement table by nonfiling financial institutions").
[22] *Id*. at 413.
[23] *Id*. at 439. Along similar lines, courts have recognized a legal duty that requires ESOP and ERISA plan fiduciaries to bring meritorious derivative actions on behalf of plan beneficiaries. *See Martin v. Feilen*, 965 F.2d 660, 667 (8th Cir. 1992) (ESOP); *Herman v. Mercantile Bank, N.A.*, 137 F.3d 584, 587 (8th Cir. 1998) (ERISA).
[24] *Cox & Thomas II*, at 440.

actions in 11 states.[25] Some of these cases were dismissed. [26] Some were settled.[27]

The lessons for asset manager fiduciaries are obvious, and the parallels between class actions and corporate actions are striking. Like settlements in securities class actions, the full value of a corporate action is available and recoverable. Like settlements in securities class actions, the investor beneficiary is entitled to capture the full value of a corporate action. It is not additional income. It does not involve additional risk. It is the undisputed property of the investor beneficiary. Whether in the context of class actions or corporate actions, the lesson is the same. Asset manager fiduciaries (or the custodians acting on their behalf) must have systems in place that value the claim for recovery, and systems that process the claim such that the full value is captured for the investor beneficiaries. This is especially true for fiduciaries entrusted with investments from private and public pension funds.[28]

These lessons did no go down easily. Professors Cox and Thomas were told by some fund managers that fund resources should be fully devoted to "beating the market," or that the expected gains of filing claims for class action recovery "were dwarfed by both the size of the fund's assets and the average yearly returns earned by the fund through wise investment strategies."[29] The professors explored both topics in depth, concluding just the opposite. The costs of identifying and filing class action claims are, in fact, low because they involve administrative tasks that can be accomplished by third-party service providers or middle/back-office personnel.[30] Nor did the professors agree that such costs were likely to be dwarfed by the potential returns, at least for the vast majority of institutional investors. To the contrary, the data collected by the professors showed that "the expected returns of such staffing would not just cover the costs of such a procedure but would likely yield a fairly high positive return."[31]

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[25] *See Class Action Lawsuits Over Class Action Settlement Funds: Are your Clients at Risk?*, 7 COMM. & BUS. LIT. 17 (ABA 2005). Targets included American Funds, Dreyfus, Janus, MassMutual, Merrill Lynch, Neuberger Berman, Putnam, Vanguard, Van Kampen, Wells Fargo, as well as their directors and fund advisors. *See id.*

[26] Some cases were dismissed because of factual deficiencies. This included, for example, failures to allege that the mutual fund owned the relevant securities during the relevant period, had received notices of claim, or had contractual authority to act on behalf of the client in legal proceedings. *See The Role of Investment Advisers in Client Class Action Claims*, 12 THE INVESTMENT LAWYER 17, 18-19 (2005). Some were dismissed because claims should have been brought derivatively, or because the court did not find a private right of action under the Investment Company Act of 1940, as amended ("ICA"), for failure to participate in class action recoveries. *See, e.g., Hamilton v. Allen*, 396 F. Supp. 2d 545 (E.D. Pa. 2005) (holding that breach of fiduciary duty claims should have been brought derivatively, and finding no private right of action under ICA §§ 36(a) or (b) against asset managers that failed to make claims in securities class actions).

[27] *See* Frederick P. Gabriel, *Have Mutual Funds Beaten Legal Rap? All But Two Of 44 Suits Have Been Resolved*, INVESTMENT NEWS (Apr. 10, 2006) ("In 'more than a handful' of cases, the fund companies agreed to cash settlements…" (*quoting* Randall K. Pulliam, plaintiffs' counsel)), *available at* http://securities.stanford.edu/resources_news_blog_excerpt.html?id=101424. Terms of the settlements were not released.

[28] *See Cox & Thomas I*, at 860-63; *Cox & Thomas II*, at 414-15 ("[P]ension fund trustees should be required to take actions to maximize the value of the assets under their management, such as filing cost-justified claims in securities fraud class action settlements, even if these actions do not create 'big money.' Using any other legal standard for trustees' fiduciary duties diminishes the value of the duty of care.").

[29] *Id.* at 431.

[30] *Id*. at 430-31.

[31] *Id*. at 431.

These are familiar explanations from custodians and asset managers in the corporate actions context, and they fail for the very same reasons. Here, too, implementing a system to satisfy the fiduciary obligations of the asset manager is a low-cost, administrative exercise. It involves either middle- or back-office personnel, or a third-party service provider (some of which receive only a percentage of the additional value recovered by the client).[32] Nor does it have any impact at all on those who are paid to conduct investment strategy. Portfolio managers continue to manage portfolios. Securities analysts continue to analyze securities. Potential returns, on the other hand, are massive. The cost-benefit calculus is clear. As with class action recovery, the costs of optimizing corporate action recovery are vastly outweighed by the potential returns.[33]

Professors Cox and Thomas also found a significant discrepancy between the claims filing practices *reported by certain fund fiduciaries*, and the claims filing practices *actually revealed in the data*.[34] This was true, for example, with pension fund respondents.[35] This, too, is a familiar refrain in the context of corporate actions. Most custodians and asset managers say that they have adequate systems in place for identifying and capturing the full value of corporate actions. Our research has shown these claims to be largely false. Most custodians and asset managers, according to our findings, are not making optimal elections. In the context of scrip dividend elections, for example, close to 95% of custodian and asset manager fiduciaries are making suboptimal elections where the optimal election is stock.

The table below is illustrative:

Propensity of The Asset Managers in The Sample to Elect Cash vs. Stock

Optimal Election	Elected Cash	Elected Stock
Cash	2498 (95.6%)	114 (4.4%)
Stock	3322 (94.6%)	190 (5.4%)

[32] Indeed, the presence of third-party service providers that take only a percentage of the amounts recovered was an important factor in the professors' cost-benefit analysis. *See id.* at 439 ("independent third-party claims filing services now provide these services in exchange for a percentage of the amounts recovered, making it difficult for institutions to continue to claim that they do not file claims because they are devoting their internal resources to higher-value uses"). The same is true here. Custodian and asset manager fiduciaries cannot claim that the costs of optimization are prohibitive when third-parties will provide the service for a percentage of the uplift.

[33] Another familiar excuse to avoid taking action in the corporate actions context is resistance from stock loan. This, too, is unavailing. Administrative concerns about stock loan should not obstruct the exercise of fiduciary obligations by an asset manager. Nor do we think that any court would absolve an asset manager of its fiduciary obligations because of administrative concerns about stock loan. We caution, moreover, that stock loan has a long history of using strong-arm tactics to protect its business and to stifle competition. These strong-arm tactics are alleged in exhaustive detail in the pending stock loan antitrust litigation. *See Iowa Public Employees Retirement Sys. v. Bank of Am. Corp*., No. 17-CV-6221 (S.D.N.Y. 2017).

[34] *Cox & Thomas II*, at 432-38.

[35] *Id*. at 436 (According to the professors, "[e]very pension fund respondent but one…stated that they filed all claims, with a few adding the qualifier that they excluded cases in which they were ineligible or had opted out of the class… we note that these replies are apparently inconsistent with the data reported in Part II.").

For all of the above reasons, we believe there are significant legal risks for any asset manager that chooses to ignore its fiduciary obligations. To satisfy the duty of care, asset manager fiduciaries (or the custodians acting on their behalf) must have systems in place to ensure that they comply with their obligations to collect the recovery to which their beneficiaries are entitled. In the context of corporate actions, this means systems that value corporate action determinations on the election date, and that process corporate action determinations such that the full value of the optimal election is captured for the beneficial owner.

Ignoring these fiduciary obligations is a pathway to civil liability exposure.

Section IV

Potential Solutions

The regulatory and legal risks discussed above demand action from asset managers. The solution, however, is relatively simple. Asset managers (or custodians acting on their behalf) must put in place systems that value corporate action determinations on the election date, and that process corporate action determinations such that the full value of the optimal election is captured for the beneficial owners.

In the context of scrip dividends, or rights offerings, a compliant system, at a minimum, would:

- value each possible corporate action election as of the election date;
- determine whether the election made by the custodian or asset manager is optimal or suboptimal;
- where a suboptimal election was made, change the suboptimal election to the optimal election; and
- where the optimal election is stock, lock-in the increased value for the client immediately at election.

There is no one-size-fits-all method for compliance here. Custodians and asset managers vary significantly in size, sophistication, staffing, and expertise. Some will decide that they are well-equipped to develop and implement the necessary systems themselves, and that they can satisfy their fiduciary obligations without the help of an outside firm. Others will decide either that they cannot develop and implement the necessary systems themselves, or that their internal resources are best devoted to other custodial or advisory functions, and will engage an outside firm. Either choice may be optimal, depending on the characteristics of the custodian or asset manager.

Ignoring the problem, however, is not an optimal choice for any prudent asset manager. Unfortunately, a sizable cross-section of asset managers is doing just that. As discussed in Section I of this White Paper, the failure by asset manager fiduciaries to recover the full value of property held for the benefit of investors has resulted, and continues to result, in significant losses for investors. In scrip dividends alone, these losses exceed a billion dollars a year in the aggregate. Sizable losses are also occurring in rights issues, tenders, mergers, and other corporate actions.

The numbers are stark. Asset managers that fail to maximize the value of corporate action determinations face daunting regulatory risks, as regulated entities, and take significant legal risks, as fiduciaries.

Conclusion

Asset managers are failing to optimize corporate action decisions on a massive scale. This failure has caused, and continues to cause, significant aggregate losses to investor beneficiaries. We think it is only a matter of time before regulators commence investigations and, ultimately, enforcement cases, against asset managers that systematically fail to maximize the value of corporate action determinations. Likewise, we think it is only a matter of time before civil plaintiffs commence lawsuits against asset managers that systematically fail to maximize the value of corporate action determinations.

These regulatory and legal risks deserve serious attention from the asset management community. Choosing to ignore them will cause harm not only to beneficial owners, but to the fiduciaries they entrust with their investments.

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