Briefing Note for the Committee of Public Accounts on the National Treasury Management Agency and the National Pensions Reserve Fund

6 February 2014

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Notes:

End 2013 figures contained in this briefing note are preliminary and unaudited.

The briefing note does not contain an update on the activities of the National Asset Management Agency or the National Development Finance Agency as these do not form part of the agenda for the Committee meeting on 13 February.

1. NTMA Structure

The NTMA operates with a commercial remit to provide asset and liability management services to Government. It has evolved from a single function agency managing the National Debt to a manager of a complex portfolio of public assets and liabilities. Businesses managed by the NTMA include borrowing for the Exchequer and management of the National Debt, the State Claims Agency, NewERA, the National Pensions Reserve Fund and the National Development Finance Agency. The NTMA assigns staff to the National Asset Management Agency and also provides it with business and support services and systems.

The NTMA Chief Executive currently reports directly to the Minister for Finance on the NTMA's funding and debt management and State Claims Agency functions – which have been delegated to it by Government. NewERA has been initially established on a non-statutory basis within the NTMA. Under the legislation which established the NTMA, it does not have a board and it is the Chief Executive's statutory responsibility to carry on and manage and control generally the administration and business of the Agency. The legislation provides for an over-arching Advisory Committee to assist and advise the NTMA on such matters as are referred to the Committee by the NTMA and also for a State Claims Policy Committee to provide advice on policy and procedures relating to the performance of its State Claims Agency functions. The National Pensions Reserve Fund, the National Development Finance Agency and the National Asset Management Agency each have their own board.

Last June the Government announced legislative proposals to establish the Ireland Strategic Investment Fund by converting the National Pensions Reserve Fund into a fund focused on commercial investment in Ireland and to put NewERA on a statutory footing. In tandem, the Government announced, based on proposals put forward by the NTMA, that it would take the opportunity to streamline the NTMA's corporate governance structures to enable it take a more integrated approach to the performance of its functions. This new structure will involve the oversight of all NTMA activities, other than NAMA, by a new over-arching board which will be responsible to the Minister for Finance. The various boards and committees which will no longer be required under the new structure, the NTMA Advisory Committee, the State Claims Policy Committee, the NPRF Commission and the NDFA Board, will be dissolved. No changes are proposed to the existing arrangements in respect of NAMA which will continue to have its own separate board.

The Minister for Finance has announced that he intends to appoint Mr Willie Walsh, Chief Executive of International Airlines Group, as Chairperson of the new NTMA board, when established. Mr Walsh has been appointed Chairperson of the NTMA Advisory Committee.

Staff numbers in the NTMA have risen markedly since end 2009 mainly as a result of additional activities which Government has asked the NTMA to carry out over the period: NAMA, banking system functions of the Minister for Finance[1] and NewERA. Numbers have risen from 169 at end 2009 to 657 at end 2013, of whom 331 were assigned to NAMA.

NTMA Staffing at End 2013	
Funding and Debt Management	15
State Claims Agency	77
NewERA	13
National Pensions Reserve Fund	15
National Development Finance Agency	52
National Asset Management Agency	331
Banking Unit (on secondment to Department of Finance)	14
Finance, Technology and Risk	98
HR and Corporate Services	10
Legal, Control and Compliance	18
Other	14
Total	**657**

Other than a small number of staff reassigned from other functions within the NTMA, NAMA staff are employed on the basis of specified purpose contracts - their employment lasts for as long as NAMA requires their particular function. NAMA reimburses the NTMA the costs incurred by the NTMA in assigning staff and providing business and support services to NAMA.

[1] From March 2010 to August 2011 the NTMA's functions included certain banking system functions of the Minister for Finance related to the oversight and management of the State's interest and holdings in those financial institutions covered by the 2008 Government guarantee. The delegation of banking system functions to the NTMA was revoked with effect from 5 August 2011 and the NTMA banking team has been seconded to the Department of Finance.

2. Funding and Debt Management

Market Re-Entry

Following Ireland's entry into the EU/IMF programme at the end of 2010, our credibility among institutional investors had greatly diminished. From 2011, the NTMA began the process of re-engaging with investors to rebuild damaged relationships, develop new ones and ultimately pave the way for eventual return to bond issuance.

This proactive and intensive investor relations programme has formed a central plank of the NTMA's strategy to re-enter the markets and enable Ireland to successfully exit the EU/IMF programme. It has involved a structured programme of face-to-face meetings putting the investment case for Ireland to investors in Europe, the US, the Middle East, Asia and to the domestic market. The NTMA will continue its active investor relations programme in 2014 as it completes the process of market normalisation.

On 7 January 2014 the NTMA issued a new 10 year bond by syndication. The new €3.75 billion benchmark bond was priced at a spread of 166 basis points over the 10-year German bund for a yield of 3.543%.

Although the order book amounted to €14 billion, the NTMA decided to limit the size of the new bond to €3.75 billion in order to leave capacity for bond auctions in its funding programme for 2014. Some 400 investors participated in the transaction with the largest share of demand coming from abroad, particularly pan-European and US real money accounts. There was notable demand from the UK (26%) and Nordic regions (15%) as well the US (14%), with strong support from the domestic investor base (17%). Forty nine per cent of the take up was from fund managers with banks comprising 27% and pension funds 10%.

This transaction is part of the process of normalising Ireland's market access – it was necessary to demonstrate that Ireland had full market access having exited the EU/IMF programme. The intensive investor relations programme made it possible to bring the new 10 year bond to the market at very short notice– it had been made clear to investors that the NTMA intended issuing early in the new year.

The successful execution of a scheduled series of bond auctions would complete the process of market normalisation. The NTMA's working plan for 2014 is to raise a total of around €8 billion as prefunding for 2015, the remainder of which it is intended to raise by way of a series of auctions involving the NTMA's network of Primary Dealers.

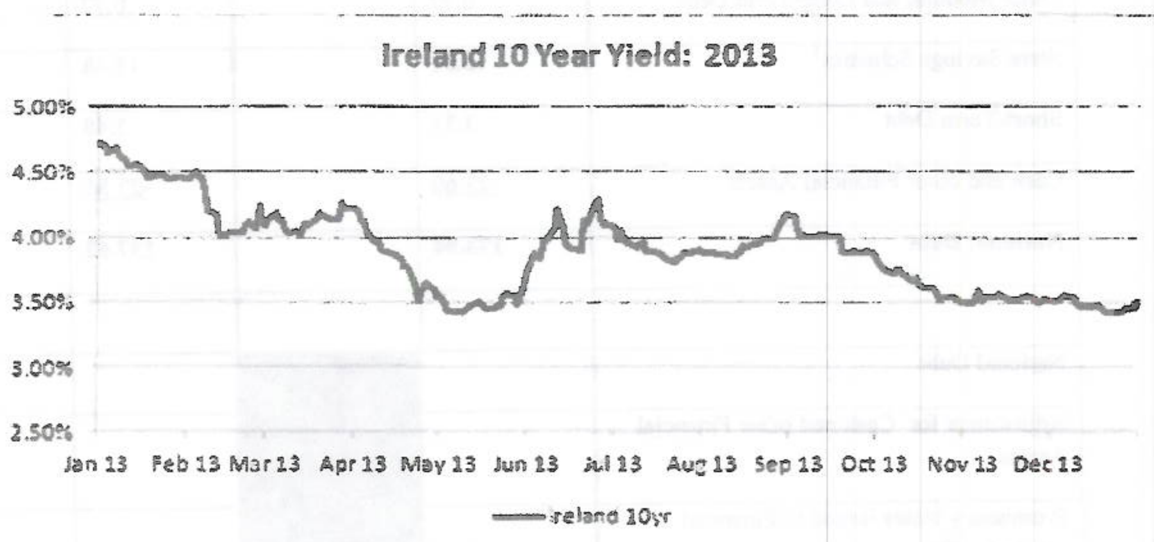
The NTMA issued €2.5 billion of the existing 5-year benchmark bond by syndication at a yield of 3.32% in January 2013 and in March 2013, sold €5 billion of a new 10-year benchmark bond by syndication at a yield of 4.15%, its first new 10-year benchmark issuance since January 2010, prior to Ireland's entry into the EU/IMF programme.

Regular auctions of short-term Treasury Bills, which resumed in July 2012, continued through 2013 with eight auctions during the year. Each auction raised €500 million of 3-month money at an average annualised yield of 0.2%.

Development in Government Bond Yields

Irish Government bonds have enjoyed a sustained rally since July 2011 when 10-year yields peaked at over 14% and 2-year yields peaked at over 22%.

The fall in Irish bond yields continued in 2013 and by end-year, 2 year yields had fallen to sub 1% and 10 year yields to circa 3.5%. The spread over the German 10 year yield contracted to circa 1.7 percentage points from over 3.0 percentage points at the end of 2012 and over 10.0 points in mid-2011.



The fall in yields in 2013 was briefly reversed in May 2013 following a similar reversal in other euro sovereign markets on fears of a tightening of US monetary policy. However, strong buying interest re-emerged in the second half of the year.

Yields have continued to decline in January 2014 assisted by the successful syndication of the new 10-year issue and the decision of Moody's to upgrade Ireland's rating back to investment grade and with a positive outlook.

Debt Profile

General Government Debt (GGD) is a measure of the total ***gross*** consolidated debt of the State and is the measure used for comparative purposes across the European Union. The National Debt is the ***net*** debt incurred by the Exchequer after taking account of cash balances and other related assets and is the principal component of GGD. GGD also includes the debt of central and local government bodies as well as promissory notes issued to a number of financial institutions. GGD is reported on a gross basis and does not net off outstanding cash

balances and other financial assets – unlike the National Debt. The NTMA's responsibilities relate to the National Debt only.

National Debt and General Government (GG) Debt				
	End- 2013		End- 2012	
€ billion	National Debt	GG Debt 2013	National Debt	GG Debt
Government Bonds	111.01		87.85	
EU/IMF Programme Funding	66.94		55.90	
Other Medium and Long-Term Debt	0.77		0.77	
State Savings Schemes[1]	15.51		13.48	
Short-Term Debt	3.31		3.48	
Cash and other Financial Assets[2]	-23.60		-23.85	
National Debt	**173.94**		**137.63**	
National Debt				137.63
Adjustment for Cash and other Financial Assets				23.85
Promissory Notes issued to Financial Institutions[3]				25.26
Other General Government Debt Adjustments				5.72
Estimated General Government Debt				**192.46 (117.4% of GDP)**

Sources: NTMA & CSO

Notes:

[1] *State Savings also include deposits in the Post Office Savings Bank (POSB). These funds are mainly lent to the Exchequer as short-term advances. Taking into account the POSB, total State Savings outstanding at end 2013 were €18.1 billion (€16.3 billion at end-2012).*

[2] *Of which, Exchequer cash balances and other short-term liquid balances accounted for €18.5 billion at end-2013 (€19.3 billion at end-2012).*

[3] *In February 2013, €25 billion of floating rate Government bonds were issued to the Central Bank of Ireland in exchange for the Promissory Notes previously held by IBRC. However the transaction had no direct impact on GGD as the bonds replaced the Promissory Notes, effectively replacing one type of debt with another.*

General Government Debt was estimated by the Department of Finance in Budget 2014 (October 2013) to peak in 2013 at 124% of GDP before declining to just under 115% of GDP by 2016. Taking into account the €4.1 billion buyback in mid-December 2013 of the January 2014 bond, it is likely that the end 2013 GGD/GDP ratio will be below the Budget 2014 estimate.

It is estimated that the weighted average maturity of Ireland's long-term marketable and official EU/IMF programme debt was 12.5 years at end-2013 compared with 7.3 years at end 2012. The increase largely reflects the issuance of long-term floating rate bonds in February 2013 and the seven year EFSF/EFSM loan maturity extensions agreed in June 2013.

Debt Service

National Debt cash interest costs charged on the Exchequer in 2013 were €7.3 billion compared to €5.7 billion in 2012[2]. This increase reflects the growth in the stock of National Debt generally, including the first interest payments on the floating rate bonds issued in February to replace the IBRC Promissory Note, as well as timing issues around some EU loan payments. Some EU loans issued in 2011 and 2012 had a first coupon payment in 2013.

Accruals data is the relevant metric in the context of the General Government Balance (GGB). Accruals data for 2013 is due for publication in April 2014. However it is expected that the overall General Government interest outturn for 2013 will be broadly in line with the Budget 2014 estimate of October last (€7.645 billion).

[2] The total Exchequer debt service cash cost – interest, sinking funds (a technical charge on the current budget which is also reflected as a receipt in the capital budget) and fees and administration expenses – in 2013 was €8.1 billion compared to €6.5 billion in 2012.

3. National Pensions Reserve Fund

The Discretionary Portfolio (the Fund excluding the Directed Portfolio described below) was valued at €6.8 billion at 31 December 2013.

The Directed Portfolio (the public policy investments in Bank of Ireland and Allied Irish Banks (AIB) made at the direction of the Minister for Finance and cash derived from the realisation in December 2013 of the Fund's preference share investment in Bank of Ireland) was valued at €13.1 billion at 31 December 2013.

The Total Fund size at 31 December 2013 was €19.9 billion.

Discretionary Portfolio

From the Fund's inception in April 2001 to 31 December 2013, the annualised performance of the Discretionary Portfolio was +3.9% per annum. The Fund's return in 2013 was +6.3%.

In light of the Government's stated intention to refocus the Fund's investment towards Ireland, since mid-2011 the Commission has adopted a twin-track approach which it believes represents a prudent and common sense means of combining adherence to the Fund's long-term mandate, reflecting its statutory responsibilities (which are to maximise long-term return subject to risks that are acceptable to the Commission), with a strategy that recognises the Government's intention to refocus the Fund's mandate on Ireland. The Fund's strategy therefore has incorporated a significant element of capital preservation – via the purchase of options and a reduced exposure to equities - while maintaining its capacity to participate in gains if markets perform well.

Since the implementation of the capital preservation strategy in July 2011, the asset allocation of the Fund had changed materially and assessing the performance of the Fund against its previous Long Term Strategic Benchmark is no longer a suitable measure of performance. A more suitable measure of relative performance is the average yield on 5 year Irish government debt, the Fund's secondary benchmark. Since July 2011 the Fund has earned an annualised return of +6.6% p.a. while the average annual yield on five year government debt has been 4.8%.

The Discretionary Portfolio asset allocation as at 31 December 2013 is set out below:

Asset Allocation 31/12/2013	**(€m)**	**% of Discretionary Portfolio**
Equities	1,703	25.0
Put Options	70	1.0
Total Equities	**1,773**	**26.0**
Fixed Income	903	13.2
Cash	2,744	40.3
Total Financial Assets	**3,647**	**53.5**
Private Equity	121	1.8
Property	355	5.2
Commodities	335	4.9
Infrastructure	341	5.0
Absolute Return Funds	246	3.6
Total Alternative Assets	**1,398**	**20.5**
Total Discretionary Portfolio	**6,817**	**100.0%**

Figures may not total due to rounding

The cash figure above includes the sale executed in December and expected to complete in the coming months of approximately €800 million of global private equity fund interests to Lexington Partners, a leading global secondaries private equity specialist. The interests sold comprise investments in and commitments to 24 separate private equity funds. The sale, which was initiated in September 2013, was undertaken in the context of generating liquidity to facilitate the NPRF's transition into the Ireland Strategic Investment Fund.

Strategic Investment Fund

In anticipation of its conversion into the Ireland Strategic Investment Fund, the NPRF has been working to develop a pipeline of potential investments. A number of these have been concluded and, as a result, the NPRF now has €1.26 billion invested or committed to areas of strategic importance to the Irish economy including infrastructure, venture capital and long-term financing for SMEs.

Significant commitments made in 2013 include an investment of €375 million in three new long-term funds that are providing a total €850 million of equity, credit and restructuring/recovery investment for Irish small and medium-sized businesses and mid-sized corporates. The NPRF played a significant role in the development of the funds, all of which have established a local presence, and is a cornerstone investor in each alongside additional investment from third-party investors. In January 2014 the NPRF announced the establishment of the China Ireland Technology Growth Capital Fund which will be

capitalised at US$100 million with equal commitments from the NPRF and China Investment Corporation.

31/12/2013	NPRF Invested Capital (€m)	NPRF Commitment Capital (€m)	3rd Party Capital (€m)	Total Project Size (€m)	Multiple of NPRF Commitment
SME Equity Fund - Better Capital	0	50	50	100	2.0x
SME Equity Fund - Cardinal Carlyle	-	125	125	250	2.0x
SME Credit Fund - BlueBay	40	200	250	450	2.3x
China Ireland Technology Fund	12	72	36	72	1.0x
Innovation Fund Ireland	48	125	125	250	2.0x
Local Venture Capital Funds	42	81	320	401	5.0x
Silicon Valley Bank	6	36	72	72	2.0x
Irish Water	162	250	-	250	1.0x
Irish Infrastructure Fund	86	250	66	316	1.3x
Irish Forestry	35	35	187	223	6.3x
PPP Schools Bundle 3		14	121	121	8.6x
PPP N11		18	165	165	9.2x
Committed to Date	**431**	**1,257**	**1,517**	**2,670**	**2.1x**

The NPRF's commitments to date represent 18.4% of the value of the Discretionary Portfolio. The NPRF's total commitments, including expected commitments of €119 million which have not yet been finalised, represent 20.2% of the value of the Discretionary Portfolio.

State Street Transition Management Update

The NTMA indicated at the November 2012 meeting with the PAC that, having received €3.2 million from State Street Bank Europe (SSBE) as repayment of the unauthorised commissions, it was awaiting the publication of a report by the UK Financial Conduct Authority (FCA) to determine whether any further action should be taken including in respect of the indexed equity mandates managed by State Street Global Advisors (SSGA), a separate company within the State Street group. The NTMA advised that the wider relationship with State Street was at risk pending the outcome of the FCA investigation.

At the November 2012 meeting, the NTMA committed to contacting the FCA to determine the likely timeframe and status of their investigation into the activities of SSBE, to providing the FCA with a transcript of the Committee's discussion of the State Street incident and to providing in due course a copy of any published FCA reports to the Committee.

Following the November 2012 meeting, the NTMA wrote to the Chairman of the FCA and provided a transcript of the Committee's discussion. The NTMA was also in periodic communication with FCA officials throughout 2013.

Separately, the NTMA has continued to provide support to the City of London Police's investigation into this matter and this support remains ongoing.

The FCA announced in March 2013 that it would be undertaking a thematic review of the transition management business. The FCA has not yet published any findings but at a conference in November 2013 the FCA's Director of Supervision provided a verbal update on the FCA's examination of the transition management industry. He noted that much of the required change identified by the FCA in terms of improved transparency was already underway and appeared to have been partly driven by client demands.

On 31 January 2014 the FCA published its report in relation to the unauthorised overcharging applied by State Street UK's[3] Transition Management (TM) business and imposed a fine of stg£22.9 million. The FCA's report is highly critical of State Street UK and states that its transition management business deliberately overcharged six clients a total of US$20.2 million. The report cited significant failings in culture and controls (including in the areas of segregation of duties, legal, compliance, audit, risk management and governance) that allowed deliberate overcharging to take place and to continue undetected. The FCA concluded there had been systemic weaknesses in State Street UK's business practices and control environment around the TM business and they considered these failings to be at the most serious end of the spectrum. Copies of the FCA's Press Release and Final Notice are attached as appendices 1 and 2.

In light of the FCA's findings, the National Pensions Reserve Fund Commission on 3 February 2014 terminated the services of State Street Global Advisors as an indexed equity manager for the NPRF.

Directed Investments

The Fund's directed investments are set out below:

Directed Portfolio 31 December 2013		
Allied Irish Banks	Value (€bn)	Ownership
Preference shares	3.5	
Ordinary shares	6.5	
Total AIB	**10.0**	**99.8%**
Bank of Ireland		
Preference shares	-	
Ordinary shares	1.1	
Total Bank of Ireland	**1.1**	**13.9%**
Cash		
Total Cash	**1.9**	
Total Directed Investments	13.1	

Figures may not total due to rounding

[3] The FCA in its statement defines State Street UK as meaning State Street Bank Europe Limited and State Street Global Markets International Limited.

The cash holding represent the proceeds of the realisation in December 2013 of the Fund's preference share investments in Bank of Ireland. In January 2014, this holding was invested (under Ministerial direction) in 3 month Irish Exchequer Notes.

4. State Claims Agency

The NTMA is designated as the State Claims Agency (SCA) when performing the claims management and risk management functions delegated to it under the *National Treasury Management Agency (Amendment) Act 2000*. The SCA's principal objectives are:

- to ensure that the State's liabilities in relation to personal injury and property damage claims, and the expenses of the SCA in relation to their management, are contained at the lowest achievable level; and
- to implement its employer liability, public liability and clinical risk work programmes, including the minimisation of litigation risk factors in State authorities and healthcare enterprises, and the implementation and audit of risk management systems.

The SCA's remit covers claims against certain State authorities, including the State itself, Government ministers, the Attorney General, health enterprises, the Commissioner of An Garda Síochána, prison governors, community and comprehensive schools and various other bodies. There are 54 State authorities within the SCA's remit.

At end 2013 the SCA had 6,188 claims under management. The estimated liability against all active claims was €1.2 billion. The breakdown of the claims is as follows:

Active Claims at End 2013		
	Claims	Estimated Outstanding Liability €m
Personal injury (non-clinical) and third-party property damage	3,127	187
Personal injury (clinical)	3,061	1,037
Total	**6,188**	**1,224**

The SCA has achieved significant savings in the management of clinical claims in 2013. While an independent actuarial assessment projected that €154 million would be required to meet the costs of clinical claims in 2013, the actual cost of clinical claims was €120 million.

The Government has decided to establish a Legal Costs Unit within the State Claims Agency. The purpose of the Unit will be to deal with third party costs arising from the Mahon and Moriarty Tribunals with a view to ultimately extending the Unit's remit to the Smithwick Tribunal. The NTMA has agreed to establish and operate the Legal Costs Unit on an administrative basis pending the establishment of the Unit on a statutory basis. The Legal

Costs Unit has secured savings of 50% on the €4.2 million of tribunal-related legal expense claims it has reviewed since it became operational in February 2013.

5. NewERA

In September 2011 the Government announced the establishment of the New Economy and Recovery Authority (NewERA), initially on a non-statutory basis, within the NTMA. The core role of NewERA involves the oversight of the financial performance, corporate strategy, capital and investment plans of the five commercial State entities within its remit - ESB, Bord Gáis Éireann (BGE), EirGrid, Bord na Móna and Coillte - and working with stakeholders to develop and structure proposals for investment in energy, broadband, water and forestry to support economic activity. NewERA's role also involves, where requested, advising on the disposal or restructuring of State assets.

NewERA has developed, in conjunction with the relevant Departments, a shareholders' expectations framework intended to aid in establishing clarity and alignment of objectives of the shareholder and the relevant commercial State entity. The framework includes the following:

- Dividends;
- Shareholder returns;
- Policy objectives (as defined by the Departments);
- Reporting requirements.

A framework letter has been issued to the ESB and it is intended to agree similar letters with the other entities within NewERA's remit. NewERA has reviewed the dividend policy of ESB and provided advice to the relevant Government Departments on a revised dividend policy, as announced by ESB in October 2013, which will provide an increased dividend payout ratio from 2015, so that by 2017 a target ratio of 40% of normalised profits after tax will have been achieved, while having regard to ESB's investment grade credit rating.

NewERA has provided detailed financial analysis and recommendations to relevant Ministers on requests for advice concerning the commercial State entities. These requests primarily stem from legislative obligations on commercial State entities to seek Ministerial approval (e.g. for an entity to borrow) or arise under the Code of Practice for the Governance of State Bodies. During 2013 NewERA provided detailed financial analysis and recommendations (where appropriate) to relevant Ministers on a total of 36 requests (2012: 45) for advice, including €2.9 billion in financing-related requests (2012: €2.5 billion) and €0.6 billion in capital expenditure requests (2012: €1 billion).

NewERA is undertaking financial analysis for the shareholder Departments to establish how a beneficial merger of Bord na Móna and Coillte might be given effect.

NewERA provided advice and project management services to the Government in relation to the sale of BGE's energy business. Following the announcement on 27 November by the Minister for Communications, Energy and Natural Resources that bids received at that date

were not acceptable, further interaction with bidders resulted in revised bids which offered materially increased value. A consortium comprising Centrica plc, Brookfield Renewable Power Inc and iCON Infrastructure was selected on 12 December as the preferred bidder on the basis of its revised bid which has an enterprise value of up to €1.12 billion.

NewERA also worked closely with ESB and provided advice to the relevant Government Departments in relation to the sale in November 2013 of ESB's 50% shareholding in UK-based Marchwood Power Ltd.

NewERA is providing advice to the Department of the Environment, Community and Local Government on certain financial aspects of the establishment of Irish Water. This has included:

- Construction of a financial model to assist Government in the assessment of Irish Water's likely annual funding requirements;
- Advising on potential capital structures that meet various accounting and credit rating constraints;
- Input into draft legislation in relation to capital structure and corporate governance arrangements for Irish Water; and
- Engagement with the National Pensions Reserve Fund regarding provision of funding by the NPRF to Irish Water.

NewERA continues to work with the relevant Government Departments and other stakeholders on investment initiatives in the areas of energy retrofit, export wind and broadband. It has assisted the Department of Communications, Energy and Natural Resources in establishing the €70 million Energy Efficiency Fund, which is a key step in developing innovative funding solutions in the energy retrofit sector.

Appendix 1

Financial Conduct Authority Press Release

31 January 2014

State Street UK fined £22.9m by Financial Conduct Authority for Transitions Management failings

Published: 31/01/2014 Last Modified: 31/01/2014

State Street UK has been fined £22,885,000 by the Financial Conduct Authority (FCA). State Street UK's Transitions Management (TM) business had developed and executed a deliberate strategy to charge clients substantial mark-ups on certain transitions, in addition to the agreed management fee or commission. These mark-ups had not been agreed by the clients and were concealed from them.

TM is a service provided to clients to support structural changes to asset portfolios with the intention of managing risk and increasing returns. TM services may be required when a client needs a large portfolio of securities to be restructured, or when a client decides to remove or replace asset managers.

Tracey McDermott, director of enforcement and financial crime, said:

"The findings we publish today are another example of a firm that has acted with complete disregard for the interests of its customers. State Street UK allowed a culture to develop in the UK TM business which prioritised revenue generation over the interests of its customers. State Street UK's significant failings in culture and controls allowed deliberate overcharging to take place and to continue undetected. Their conduct has fallen far short of our expectations. Firms should be in no doubt that the spotlight will remain on wholesale conduct."

Between June 2010 and September 2011 the FCA found that State Street UK's TM business deliberately overcharged six clients a total of $20,169,603. State Street UK's clients include large investment management firms and pension funds holding the funds and savings of retail investors.

The systemic weaknesses in State Street UK's business practices and control environment around the UK TM business were so serious that the overcharging only came to light after a client notified staff that it had identified mark-ups on certain trades that had not been agreed. Those responsible then incorrectly claimed both to the client and later to State Street UK's compliance department that the charging was an inadvertent error, and arranged for a substantial rebate to be paid on that false basis. They deliberately failed to disclose the existence of further mark-ups on other trades conducted as part of the same transition.

The FCA views State Street UK's failings to be at the most serious end of the spectrum. State Street UK acted as an agent to its TM clients and held itself out as being a trusted advisor. Accordingly, it breached a position of trust. Further, the overcharging accounted for over a quarter of its TM revenue.

When the failings were uncovered, State Street UK was found to have breached three of the FCA's Principles of Business: it failed to treat its customers fairly; it failed to communicate with clients in a way that was clear, fair and not misleading; and it failed to take reasonable care to organise and control its affairs responsibly, with adequate risk systems.

Once senior management became aware of the issue State Street UK took action to investigate the misconduct and to implement a comprehensive programme to improve the UK TM business controls and bolster control functions, governance and culture across its UK businesses.

State Street UK agreed to settle at an early stage of the FCA's investigation and has therefore qualified for a 30% discount. Were it not for this discount, the FCA would have imposed a financial penalty of £32,692,800 on State Street UK.

Note

State Street UK means State Street Bank Europe Limited and State Street Global Markets International Limited.

Appendix 2

Financial Conduct Authority

Final Notice to State Street Bank Europe Limited, and State Street Global Markets International Limited

Financial Conduct Authority

FCA
FINANCIAL CONDUCT AUTHORITY

FINAL NOTICE

To:	**State Street Bank Europe Limited; and** **State Street Global Markets International Limited**
Of:	**20 Churchill Place** **London** **E14 5HJ**
Firm Reference Numbers:	**187358 & 194525**
Date:	**30 January 2014**

1. ACTION

1.1. For the reasons given in this notice, the Authority has decided to impose on State Street Bank Europe Limited and State Street Global Markets International Limited (together, "State Street UK") a financial penalty of £22,885,000. This penalty is in respect of breaches of Principle 6, 7 and 3 of the Authority's Principles for Businesses during the period 1 January 2010 to 30 September 2011 ("the Relevant Period").

1.2. State Street UK agreed to settle at an early stage of the Authority's investigation and has therefore qualified for a 30% (Stage 1) discount under the Authority's executive settlement procedures. Were it not for this discount, the Authority would have imposed a financial penalty of £32,692,800 on State Street UK.

2. SUMMARY OF REASONS

2.1. The State Street group is a global financial services company, headquartered in the USA and operating in the UK through a number of legal entities including those described in this Final Notice as State Street UK. One of the investment services State Street offers is transition management, carrying out major structural changes to asset portfolios on a client's behalf. Those services are carried out in Europe and the Middle East by the UK transition management business ("State Street UK's TM business" or the "UK TM business"). This forms part of the Portfolio Solutions Group ("PSG") global business line.

2.2. In the Relevant Period State Street UK failed to treat its customers fairly by allowing a culture to develop in the UK TM business which prioritised revenue generation over the interests of customers. As a result, the UK TM business developed and executed a deliberate and targeted strategy to charge substantial mark-ups on certain transitions, in addition to the agreed management fee or commission, that were deliberately not agreed with clients or disclosed to them. This strategy was used on the transitions carried out for six clients, who were overcharged by a total of $20,169,603 in the period between June 2010 and September 2011.

2.3. State Street UK failed to communicate with its clients in a way which was clear, fair and not misleading because the UK TM business deliberately misrepresented State Street UK's earnings from particular transitions in certain of its communications with clients, including pre-trade estimates and post-trade reporting. State Street UK also falsely held itself out in two instances as complying with the T-Charter, a statement of industry best practice to which State Street UK was a signatory, when it did not do so.

2.4. Throughout the Relevant Period State Street UK failed to take reasonable care to organise and control its affairs effectively with adequate risk management systems. The State Street group's matrix management framework meant that EMEA PSG management were not effectively challenged by State Street UK senior management. State Street UK's business line controls and control functions did not ensure that TM documentation, the trading process, or communications with clients were adequately monitored. Existing processes were easily circumvented by EMEA PSG management and employees.

2.5. The misconduct within the UK TM business only came to light after a client notified staff that it had identified mark-ups on certain trades that had not been

agreed. State Street UK's control weaknesses were such that members of PSG senior management were able to claim to the client that this was an inadvertent error, and to arrange for a substantial rebate to be paid on that false basis. Further, members of PSG senior management deliberately failed to disclose the existence of further mark-ups on other trades conducted as part of the same transition, concealed these both from the client and from State Street UK Compliance, and did not disclose them to State Street UK senior management. Concerns were subsequently identified by State Street UK management outside PSG, and an internal investigation was commenced in September 2011. State Street UK initially contacted the clients affected in October 2011 and has since provided rebates, or offered to provide rebates, of all the amounts overcharged.

2.6. The Authority views State Street UK's failings as particularly serious for the following reasons:

(1) State Street UK's failings caused six of its clients to be deliberately overcharged by a total of $20,169,603 by the UK TM business in order for it to meet its challenging revenue targets. Overcharging occurred on only 3.5% of the transitions in the Relevant Period but generated over 25% of the total revenue earned by State Street UK in connection with its UK TM business in that period;

(2) In carrying out TM services for its clients, State Street UK acted as agent to its clients, and held itself out as being a trusted advisor. In one of the relevant transition agreements, State Street UK agreed to act as a fiduciary. Accordingly, State Street UK breached a position of trust;

(3) State Street UK's clients include large investment management firms and pension funds holding the funds and savings of retail investors. Accordingly, the actions of the UK TM business in the wholesale market caused a risk of serious detriment to retail investors; and

(4) The systemic weaknesses in State Street UK's control environment around the UK TM business were so serious that the overcharging remained undetected until the end of the Relevant Period when it was identified by a client.

2.7. The Authority's operational objectives include: (a) securing an appropriate degree of protection for consumers; and (b) protecting and enhancing the integrity of the UK financial system, which includes seeking to ensure that it is not used for a purpose connected with financial crime. State Street UK's failings threatened

these objectives. State Street UK's conduct resulted in breaches of Principles 6, 7 and 3 during the Relevant Period. Accordingly, the Authority considers that State Street UK's failures merit the imposition of a substantial financial penalty.

2.8. The Authority acknowledges that, when UK senior management became aware of the issue, State Street UK took prompt action to investigate the misconduct and has since implemented a comprehensive remediation programme in relation to the controls around the UK TM business, and bolstered its control functions, governance and culture across all of its UK businesses.

2.9. The Authority therefore proposes to impose a financial penalty on State Street UK in the amount of £22,885,000 pursuant to section 206 of the Act.

3. DEFINITIONS

3.1. The following definitions are used in this Final Notice.

"the Act" means the Financial Services and Markets Act 2000;

"the Authority" means the body corporate previously known as the Financial Services Authority and renamed on 1 April 2013 as the Financial Conduct Authority;

"bps" or "basis points" means 1/100th of 1%;

"Compliance" means the SSGM EMEA Compliance team within State Street UK;

"DEPP" means the part of the Authority Handbook entitled "Decision Procedure and Penalties Manual";

"EMEA" means Europe, Middle East and Africa, one of the geographical regions into which State Street Group's global business lines were split;

"EMEA PSG" means the Portfolio Solutions Group within State Street UK which is headquartered in London;

"Fx" means Foreign Exchange;

"Finance" means the State Street UK Finance Department;

"Global PSG" means the Global Portfolio Solutions Group of the State Street Group;

"Global PSG senior management" means senior management of State Street's Global Portfolio Solutions Group;

"Legal" means the State Street UK Legal department;

"the Principles" or "Principle" means the Authority's Principles for Businesses;

"PSG" means the Portfolio Solutions Group;

"SMC" means the SSGM EMEA Senior Management Committee;

"Relevant Period" means from 1 January 2010 to 30 September 2011;

"State Street" or the "State Street Group" is the State Street global financial services organisation which provides investment services including transition management services;

"State Street UK" or "the Firm" means the two entities listed at the header of this Notice;

"SSGM" means State Street Global Markets, one of the State Street Group's major business divisions;

"Skilled Person" means the accountancy firm appointed under s166 of the Act to prepare a report into State Street UK's TM business;

"TM" means Transition Management;

"TMA" means Transition Management Agreement;

"the Tribunal" means the Upper Tribunal (Tax and Chancery Chamber);

"UK ExCo" means the State Street UK Executive Committee; and

"UK TM business" means the transition management business within EMEA PSG.

4. FACTS AND MATTERS

Firm Background

4.1. State Street is a global financial services organisation which provides investment servicing, investment management, and research and trading services to institutional investors including: mutual funds, collective investment funds,

corporate and public pension funds, insurance companies, foundations, endowments and investment managers.

4.2. State Street is comprised of four global business divisions one of which is State Street Global Markets ("SSGM"). SSGM is organised globally into four business lines one of which is the Global Portfolio Solutions Group ("Global PSG"). Global PSG provides trading, transition management and interim/overlay services to owners and managers of asset portfolios. State Street's Global PSG operations are split and organised into three geographical regions: the Americas; Europe, Middle East, and Africa ("EMEA"), and Asia-Pacific. Its EMEA PSG operations are based in London.

4.3. State Street operates in the UK through a number of legal entities. During the Relevant Period, State Street UK's TM business formed part of its EMEA PSG which was run by EMEA PSG management. EMEA PSG was itself part of the Global PSG. The trading required to execute a transition was conducted by different entities ordinarily within State Street. The revenue derived by State Street UK from the TM business in the Relevant Period was $77,904,287.

4.4. During the Relevant Period, the oversight of EMEA PSG (and therefore the UK TM business) operated according to the matrix management framework in existence at State Street. This meant that responsibility for the TM business was shared between global business line management ("Global PSG senior management") and State Street UK senior management. In practice, the matrix management framework did not operate jointly. Instead Global PSG senior management took primary responsibility, set business targets, and assessed performance. Consequently, EMEA PSG senior management did in fact bid for and negotiate the terms on which State Street UK conducted its TM business without sign off and with little scrutiny from State Street UK senior management.

4.5. EMEA PSG performance, including the performance of the UK TM business, was discussed in various committee meetings including the SSGM EMEA Senior Management Committee ("SMC") and the State Street UK Executive committee ("UK ExCo"). These discussions included TM deals in the pipeline and EMEA PSG performance to budget. No granular Management Information was provided by EMEA PSG management to these governance bodies on a transition by transition basis, or any written detail regarding the reasons for changes in monthly revenue. Further, there was no analysis recorded in committee minutes of the types of transitions (for example, equity vs. fixed income), or why some transitions were more profitable than others.

Transition Management

4.6. TM is a service provided to clients to support structural changes to asset portfolios with the intention of managing risk and increasing portfolio returns. In the Relevant Period State Street UK's TM clients were predominately large investment management firms or asset owners (including pension fund trustees) holding the pension funds or savings of retail investors.

4.7. TM services may be required when a client needs a large portfolio of securities to be restructured, or when a client decides to remove or replace asset managers. For example, a typical pension fund trustee may decide to change the general type of assets (such as equities and fixed income bonds) that the pension fund should be invested in. Where the change is large and complex, the pension fund trustee may appoint a transition manager to project manage and effect the transition.

4.8. The process will generally require the TM provider to use hedging instruments to minimise exposure before selling one portfolio and buying another and effecting any Fx required.

4.9. A transition manager can charge fees and generate revenue in a number of different ways. It can charge commissions on equities and futures trades, mark-ups on bonds, and/or it can charge a project management fee (which can either be a fixed fee, or a fee based on a percentage of the overall portfolio).

4.10. The main performance indicator, and the basis upon which transition managers generally compete for transitions, is the "implementation shortfall", which equates to the frictional cost of moving from one portfolio allocation to another and includes the explicit costs as well as the market impact incurred prior to completion of the transition as compared to the legacy portfolio's performance. Implementation shortfall is sometimes referred to as the "performance drag" on a portfolio; it is, in effect, the true cost of a transition to an asset owner.

4.11. The implementation shortfall comprises a number of different components including: (a) commissions, mark-ups and/or project management fees (which, as set out above, are charged by the transition manager), and taxes which are together referred to as "explicit costs"; and (b) trading costs such as the bid-ask spread, market impact, and opportunity costs which are together referred to as "implicit costs."

State Street UK typical charging model

4.12. There are significant differences between the TM models of the leading TM providers in the industry. Some TM providers (such as investment banks) can trade as principal with their clients and can earn revenue for themselves by charging a spread. The UK TM business marketed itself in client proposals as offering a unique TM model, which was derived from State Street UK's un-conflicted, fiduciary role. Unlike investment banks offering TM services, the UK TM business claimed that State Street UK could avoid the conflicts that would be created through executing transitions and also running a proprietary trading book.

4.13. In a proposal document produced for a pension provider in October 2010, State Street UK noted: *"It is our responsibility as transition manager to minimize the overall implementation shortfall, which includes both explicit and implicit costs."*

4.14. In 2007 State Street UK was a founding signatory to the T-Charter; a voluntary, best-practice code for transition managers. The T-Charter sets out a number of principles relating to disclosure and remuneration, and in particular states that the transition manager will not apply dealing commission or charges, adjust prices or apply a mark-up or mark-down other than as agreed with the client in the contracting documentation and as disclosed in a disclosure document. State Street UK's TM business explicitly held itself out to various TM clients as adhering to the principles contained in the T-Charter.

4.15. To earn revenue on a transition, the UK TM business typically agreed to charge a client a commission when trading in equities and took a disclosed spread or mark-up on any fixed income transitions. On occasion, a fixed management fee would be charged instead of a commission or spread. In addition to these sources of revenue, State Street UK would also generate revenue from the Fx and futures transactions it carried out as part of a transition.

4.16. State Street UK's TM business would typically outline the revenue and charges noted in paragraph 4.15 above in a transparent way in the key contractual documentation: the TMA (the master agreement for each client outlining how TM services will be provided); and/or the Periodic or Transition Notice (an Appendix that was signed for each transition, which referred back to the TMA, and provided more specific details of individual transitions). Fx revenue, which would typically be earned by a State Street entity acting as principal on a disclosed basis, would not generally be specified. State Street UK's TM business would also typically set out the revenue and charges which the implementation shortfall was comprised of in both the pre and post-trade analysis reports provided to clients.

Departures from the typical charging model

4.17. During 2008 and 2009 there was a significant withdrawal of competition from the TM market and EMEA PSG won a large number of transitions for clients who were seeking to restructure their asset portfolios. The return of a number of competitors to the market during 2010, and a shortage of major TM deals of the scale of those seen during 2009, had a significant impact on the financial performance of the EMEA PSG business in 2010.

4.18. As a result of these market pressures, in May 2010 members of PSG senior management discussed new ways of earning revenue. On certain transitions from June 2010 the UK TM business moved away from the typical charging model so as to earn additional revenues from mark-ups to trade prices that were not agreed with or disclosed to the clients concerned. This was done in three transitions in the second half of 2010.

4.19. In late 2010 or early 2011 this approach was discussed among EMEA PSG management and PSG senior management. When concerns were raised by some members of EMEA PSG management about the UK TM business moving away from its typical charging model on some transitions, PSG senior management claimed that this practice was operated by State Street UK's competitors, permitted under the terms of State Street UK's standard agreements with its TM clients, and approved by Legal. EMEA PSG management were prepared to accept the assurances from PSG senior management and failed to raise any concerns with State Street UK's Legal or Compliance functions (who were not aware of and had not approved any strategy to apply undisclosed mark-ups or charges on transitions). By doing so, EMEA PSG management gave legitimacy to this practice to more junior employees in the TM business.

4.20. The new charging model was deployed on the transitions conducted for six clients during the Relevant Period, as set out below. In each case, the practice of applying undisclosed mark-ups was not raised with Compliance or Legal, and was not disclosed or escalated to anyone outside of the PSG.

<u>Client A</u>

4.21. State Street UK's TM business conducted a large and complex transition for Client A involving both fixed income and equities trading. The transition was split into three tranches, with separate client reporting for each tranche. The total value of the three tranches was approximately €4.7 billion. The UK TM business applied

undisclosed commissions and mark-ups to the equity and fixed income trades which had not been expressly agreed by Client A.

4.22. In deciding what bid to make to Client A, a series of emails were sent between members of PSG senior management which included the following comments on how revenue would be earned from the transition:

"Gotta win this one! Any ideas how to get more revenue would be appreciated."

"How about a 1bp management fee or something of that nature, no commissions and then take a spread? We need to charge fee then otherwise they get suspicious."

"Just to clarify - 1.25bps is the management fee. The extra quarter point makes it look like we actually thought about it and did the calculations."

4.23. A fixed management fee of 1.65bps was eventually agreed with Client A as set out in the Transition Notice. This fee was subsequently reduced to 1.25bps for the third tranche. However, members of PSG senior management continued to discuss possible other sources of revenue over email:

A: "need to be very creative here"

B: "we will."

A: "Here's what I think we should do with our new best friends[...]: - 1.65bps for the privilege of working with us [...] - 10-12 bps out of FI – 3bps spread out of US equity and global small cap – trade all global em mkt net through brokers – organise with FX to collect 5bps for trading back to euro. Perhaps the FX bit needs a discussion upfront involving you and [an individual from SSGM Sales and Trading Research], but we HAVE to show revenue in our numbers".

B: "... Fx won't be a problem."

4.24. In addition to the agreed fixed management fee, the UK TM business charged Client A undisclosed commissions on the equity trades on both tranche one and tranche three. The UK TM business also charged undisclosed mark-ups on the fixed income trades across all three tranches. The mark-ups to the fixed income trades were on average 1.4bps on tranche one, 1.94bps on tranche two and 2.91bps on tranche three. The Authority has found no evidence of mark-ups on the Fx trading.

4.25. In order to disguise the commissions added to the equity trades, EMEA PSG management agreed to book the trades through a trading account which was typically used for non-TM business to provide an average price to clients for a day's trading. However, this was not a situation where average prices were being used. Instead, at the direction of EMEA PSG senior management, EMEA PSG management extracted trade data from the trading records, added commissions, and then uploaded the adjusted equity prices into the trading records. The use of the account in this way meant that the commissions added to the equity trades would not be visible to Client A.

4.26. Written trading instructions were issued to the trading desks, specifying that there were to be no commissions applied to the fixed income trades. However, contrary to the agreement with Client A, further instructions were then provided by members of PSG senior management to traders in the UK and the US that mark-ups should be applied. The Authority has not found any evidence of written instructions which justify these mark-ups.

4.27. The application of mark-ups was questioned by a senior Global PSG individual ("Individual A"), who was told by EMEA PSG management:

"its on a need to know basis... speak with [Global PSG senior management who] *knows the strategy here."*

4.28. Individual A then forwarded the query to Global PSG senior management and asked: *"care to share? I want to make sure I tell Finance the right amount to accrue, looks like we are recognising revenues on the fixed income and futures* [EMEA PSG management] *refrrd [sic] me to you."* The response from Global PSG senior management stated: *"1.75 bps on value traded. Will also have revenue potentially from etf redemption."*

4.29. The Authority has found no evidence of any discussion of this issue between anyone in PSG and any employee of State Street outside of PSG. Further, the issue of applying mark-ups on an undisclosed basis when a fixed fee had been agreed, was not raised with Compliance or Legal and was not disclosed or escalated to anyone outside PSG.

4.30. State Street UK's total agreed contractual fee for Client A's transitions was $1,634,085. However, State Street UK earned additional illegitimate revenue of $3,709,187 from the undisclosed mark-ups and commissions that were applied on this transition.

Client B

4.31. State Street UK's TM business carried out a transition for Client B involving the restructuring of a £850 million bond portfolio. State Street UK's TM business agreed to perform the transition for a fixed management fee of £350,000.

4.32. The TMA permitted State Street UK to earn a spread on fixed income trades in lieu of commission, but specified that any such spread was to be specifically identified in the Transition Notice. The Transition Notice provided to Client B referred to the agreed fixed management fee of £350,000 but it made no reference to the earning of a spread.

4.33. No mark-ups were built into the pre-trade estimate provided to Client B. However, during trading, an average undisclosed mark-up of 0.55bps was applied to fixed income trades in addition to the agreed fixed management fee. The post-transition analysis report provided to Client B did not refer to the mark-ups which had been applied to the fixed income trades, and only referred to the agreed management fee of £350,000. The actual post implementation shortfall reported to Client B after the transition had completed was significantly under the pre-trade estimate due to favourable market conditions. However, the full benefit of these market conditions was not passed on to Client B. Instead, a mark-up which had not been agreed with Client B was earned and concealed within the bid-ask spread line in the post-trade analysis report which was provided to Client B.

4.34. State Street UK earned additional illegitimate revenue of $1,003,375 from the undisclosed mark-ups that were applied to the fixed income trades on this transition.

Client C

4.35. State Street UK's TM business carried out a €1.6 billion transition involving the restructuring of the Euro-denominated fixed income portfolios of two pension funds managed by Client C.

4.36. Ahead of the transition, Client C was informed by State Street UK's TM business that:

"The transition team will provide transparent implementation shortfall reporting, highlighting the transition related cost. This allows for a clear cost and performance attribution."

4.37. Before trading commenced, Client C informed the UK TM business that all futures should be executed through its broker rather than via State Street UK's futures broker. An email sent between members of PSG senior management commented on the impact of losing the futures mandate for State Street UK's potential earnings from the transition:

"Just have to charge a bit more given that we don't get futures revenue."

4.38. Correspondence with Client C indicated that it was agreed that State Street UK would earn a 1bp mark-up on the fixed income trades, which amounted to $3,368,257, and that this would be built into the spread. However, the mark-up charged was, on average, 1.5bps.

4.39. The post implementation shortfall analysis report provided to Client C contained within the bid-ask spread undisclosed mark-ups of an additional 0.5bps over and above the 1bp expressly agreed with the client. Despite having agreed 1bp with Client C, and that clear and transparent transition reporting would be provided, no separate line for the mark-up was disclosed in the post-transition report.

4.40. State Street UK earned additional illegitimate revenue of $1,574,349 from mark-ups on fixed income trades which had not been expressly agreed with Client C.

Client D

4.41. State Street UK's TM business carried out a €1 billion global equities and fixed income transition for Client D. The transition was executed in two phases. State Street UK's TM business quoted a fixed management fee of €350,000 for the transition, plus a 1bp commission on futures which totalled $547,609.

4.42. In pre-contractual negotiations Client D requested that the UK TM business:

"explicitly identify in the Transition Notice all...fees and charges and where they cannot be explicitly identified they should list all possible sources of Revenue, Futures Clearing, Bond Bid/Offer Spreads etc".

4.43. Despite the specific request from Client D, State Street UK's TM business only set out the €350,000 fixed management fee in the Transition Notice and did not disclose that any other commission or additional mark-up would be charged on the fixed income trades.

4.44. Further, State Street UK's TM business also represented to Client D in its bid proposal that State Street UK was *"fully compliant to the principles set out in the*

T-Charter" and "*believes in providing full transparency to clients.*" Compliance with the T-Charter would require the UK TM business to disclose to Client D all sources of remuneration received by it as a result of the transition.

4.45. During the execution of the transition, the trading instructions emailed to the UK trading desk stated "*zero comms*" for the fixed income trades, which meant that no mark-up should be applied. However, subsequent to this email, the trading desk applied a mark-up of approximately 0.5bps to most fixed income trades. No written trading instructions have been identified which justify the mark-ups applied to the fixed income trades.

4.46. The UK TM business failed to disclose to Client D the additional mark-ups that were charged. The undisclosed mark-ups were hidden in the bid-ask spread or opportunity cost lines of the post implementation shortfall.

4.47. The post-transition report sent to Client D only referred to the agreed fixed management fee of €350,000. State Street UK earned additional illegitimate revenue of $1,105,280 as a result of mark-ups which were not disclosed to Client D.

Client E

4.48. State Street UK's TM business performed two fixed income transitions for Client E with a combined value of approximately $6 billion during the Relevant Period.

4.49. Following communications between EMEA PSG senior management and Client E prior to the first transition, in which Client E requested that no explicit commission be charged, EMEA PSG senior management proposed to undertake the transition on a zero commission (and no management fee) basis.

4.50. In a series of communications between EMEA PSG senior management and Client E, EMEA PSG senior management made clear that State Street UK preferred to charge a disclosed commission, but in this instance it had arranged to receive:

"*a share of the spread from the 'other side' (the successful/winning counterparty for each individual security as chosen by us as your agent in a competitive bid process)*"

This representation was false; State Street UK's earnings from any mark-up on the spread would come, not from the "*other side*" but would be paid for by Client E.

4.51. Further, EMEA PSG senior management confirmed that this would amount to *"only a few"* basis points of commission and Client E would *"get the best execution in the market"*.

4.52. Client E asked EMEA PSG senior management to confirm that *"In terms of quoting zero commission"* State Street UK was in compliance with the T-Charter. EMEA PSG senior management gave such a confirmation by reference to a draft of the Periodic Notice which disclosed that the source of revenue would be mark-ups included in the spread.

4.53. The UK TM business had no further communication with Client E regarding the fees for the first transition. The post-trade analysis report provided to Client E included no reference to the mark-ups that EMEA PSG senior management had applied to Client E's trades, which amounted to $2,738,344, equivalent to 9 basis points.

4.54. These communications between EMEA PSG senior management and Client E were inadequate and misleading. Whilst it was made clear to Client E that State Street UK would earn remuneration from the transition, that was not reflected in the Periodic Notice, the UK TM business did not receive a portion of the spread from the executing broker, and the total revenue earned by State Street UK was significantly more than *"only a few"* basis points. In addition, the source and calculation of revenue was not properly disclosed. The Periodic Notice sent to Client E for signature and the executed version of the Periodic Notice did not disclose that the source of revenue would be mark-ups included in the spread as required for a firm complying with the T-Charter. Nor did the UK TM business disclose how remuneration was calculated and collected which was also a requirement of the T-Charter.

4.55. For Client E's second fixed income transition, the UK TM business again quoted a zero commission and no management fee. The Periodic Notice provided in draft to Client E stated that: *"Trades will not attract any commission and will be priced net. The manager may benefit from a bid-ask spread."* However, the signed version returned by Client E did not contain this language. There were no further communications with Client E regarding the revenues that would be earned.

4.56. On being awarded the second fixed income transition for Client E, members of EMEA PSG management exchanged emails commenting: *"Nice!"* and *"Back up the truck!"*

4.57. Shortly before the transition commenced, members of PSG senior management exchanged further emails about the extent of scrutiny by Legal of the legal documents governing the transition:

B: *"Did they [Legal] look at the original agreement?"*

A: *"Absolutely not. Nor did they look at the periodic notice. This can of worms stays closed!"*

"Btw - there is no way we can disclose our spread."

B: *"Agreed."*

4.58. The pre-trade analysis report sent to Client E for the second transition included a "market impact" estimate of approximately $5 million. This was an artificial and fictitious figure which was moved from the estimate of the bid-ask spread to the market impact line by a member of the UK TM team on instructions from EMEA PSG senior management. This presentation of the trading costs disguised the amount of the mark-up which EMEA PSG senior management expected to charge Client E.

4.59. State Street UK's earnings for the second transition were disguised within the market impact and bid-ask spread costs instead of being separately specified, thus the amount of revenue earned by State Street UK on this transition was not disclosed to Client E. The total costs listed in the post-trade analysis report include $4.7 million for market impact which was a fiction as this figure incorporated the earnings made by State Street UK from the undisclosed mark-ups which the UK TM business had applied to Client E's trades.

4.60. In addition, State Street UK's TM business failed to obtain permission before executing Fx trades required in connection with the transition despite this being required by the terms of the Periodic Notice. This failure was concealed from the client when permission was belatedly sought.

4.61. State Street UK earned a total of $9,720,062 of revenue on Client E's two transitions as a result of the mark-ups which were not disclosed to Client E.

<u>Client F</u>

4.62. State Street UK's TM business carried out a £1.3 billion transition for Client F which involved the restructuring of fixed income and liquidity mandates. The Transition Notice sent to Client F, confirmed that a fixed fee of 1.75bps *"on the*

value of the portfolio" would be charged. An additional 1bp of the *"traded value"* of futures was later agreed with Client F by email. State Street UK's total agreed fee was $922,107.

4.63. Client F asked for confirmation that the agreed fixed fee was the *"full and final transition fee including all buying and selling required."* EMEA PSG senior management confirmed that that was correct. However, following this confirmation, email correspondence between members of PSG senior management indicated an intention to apply an additional mark up on top of the agreed fixed management fee: *"I am thinking 1.5-2bpy"*.

4.64. State Street UK's TM business included an undisclosed mark-up of 1.75bps in the bid-ask spread line of the initial pre-trade analysis report. This was reduced to 0.75bps in the final pre-trade analysis report sent to Client F.

4.65. During execution, the trading instructions sent to the UK trading desk stated *"Comms: ZERO COMMS"* (which meant that no mark-up should be applied to the trades) which was consistent with the contractual documentation. However, an average mark-up of 1bp was applied to US trades, and an average mark-up of 2bps was applied to European trades. The Authority has not found any evidence of written instructions which justify these mark-ups.

4.66. When Finance queried why mark-ups of 1bps and 2bps were added when the instructions read zero commission, Individual A forwarded this query to EMEA PSG senior management and was informed that zero commissions were *"none of their concern."* There is no evidence that anyone in Finance, or Individual A, followed up on this issue, challenged anyone in EMEA PSG management further, or raised the issue with Compliance.

4.67. Futures traded as part of the transition were also conducted at a higher rate of commission than the 1bp agreed.

4.68. The post-implementation shortfall reported to Client F was almost identical to the estimate in the pre-trade analysis report, but hidden within the bid-ask spread line was $3,057,350 of illegitimate revenue earned as a result of the undisclosed mark-ups which had been applied.

4.69. Finance did not query the request from EMEA PSG senior management that a further $3 million of "missing revenue" for Client F (effectively the undisclosed mark-ups) should be added to the management accounts in May 2011.

Discovery of overcharging

4.70. On 21 June 2011, Client F contacted EMEA PSG senior management asking if the 1.75bps agreed fee, plus commissions for futures execution was *"the sole revenue for SSGM and/or any of its affiliates on this event."* EMEA PSG senior management confirmed this was correct, despite being aware that undisclosed mark-ups had been taken on the fixed income trades. Client F responded noting that their own consultant, using publicly available bond pricing information in the US, had identified mark-ups on certain US fixed income trades which had not been disclosed and which had not been expressly agreed.

4.71. EMEA PSG senior management sent a holding response to Client F stating that it *"doesn't seem right"*, despite being fully aware that undisclosed mark-ups had been deliberately applied to the US trades. Members of PSG senior management then agreed that they should provide the following inaccurate response to Client F on behalf of State Street UK:

"our trading desk in the US has erroneously applied commissions of 1 bp of yield to trades that should have gone through at zero commission."

4.72. Members of PSG senior management agreed that State Street UK would rebate Client F approximately $1 million for the mark-ups that had been applied to the US trades, describing them as *"inadvertent commissions."*

4.73. Members of PSG senior management then circumvented the usual processes and procedures to make the rebate so that it was not recorded in the loss event tracking system. As a result, the rebate was paid without alerting Compliance or State Street UK senior management to the issue.

4.74. While arranging the rebate for Client F, members of PSG senior management failed to disclose to Client F that they had also deliberately taken mark-ups on Client F's European trades, which had earned State Street UK further undisclosed revenue of approximately $2 million.

4.75. Client F appointed a third-party analyst to perform a full post-transition review, at State Street UK's cost. As part of its review, the analyst requested that Compliance provide written confirmation that the correct amount had been repaid and the error did not constitute a regulatory breach.

4.76. Compliance undertook a limited investigation of the transition and relied on assurances from members of PSG senior management that it was an isolated

error affecting the US based trades and that no applicable regulations had been breached. As a result, Compliance prepared a factually incorrect letter, based on a misleading draft provided by members of PSG senior management, stating that the mark-ups were an error and limited to the US trades to send to Client F's analyst. This letter was not sent, after concerns were escalated to State Street UK senior management by a senior individual outside of PSG following a conversation with one of the EMEA PSG managers.

Summary of overcharging

4.77. State Street UK's TM business therefore departed from its agreed charging model by overcharging six clients between June 2010 and September 2011. It also misled these clients as to the fees and charges being levied through undisclosed commissions and hidden mark-ups totalling $20,169,603 and deliberately provided false information to these clients despite holding itself out to certain clients as complying with the T-Charter.

Actions since overcharging identified

4.78. Once concerns were escalated, State Street UK commenced an internal investigation into the Client F overcharging incident in September 2011 and promptly notified the Authority. Once State Street UK senior management recognised that the overcharging issue could extend to other clients, State Street UK appointed external advisors to undertake their own independent investigation. In October 2011 State Street UK notified those clients that it understood had been overcharged based upon its investigation and notified all UK TM clients of the charging issues that had arisen. In January 2012, pursuant to a requirement by the Authority, a leading accountancy firm was appointed as a skilled person (the "Skilled Person") under s166 of the Act to prepare a report into the UK TM business during the Relevant Period. The Skilled Person's report was delivered in August 2012 and concluded that State Street UK's TM business had overcharged Clients A – F and that it should repay any outstanding amounts to the overcharged clients.

4.79. State Street UK implemented a comprehensive remediation programme, at its own initiative, to resolve the overcharging issues that arose in the UK TM business and to substantially enhance the control environment in the EMEA PSG business. This programme began before the Skilled Person had been appointed and then later encompassed a structured programme to implement the control enhancements and other recommendations set out in the Skilled Person's report.

Further, State Street UK established and resourced a central function to review and make improvements to the controls and culture across all of its UK businesses, not only the UK TM business. State Street UK has bolstered its control functions in terms of both the quality and quantity of the staff and has made several new senior level appointments within its control functions. State Street UK also dismissed various individuals centrally involved in the overcharging of TM clients.

4.80. As mentioned above, State Street UK has contacted the affected clients and has now provided rebates, or offered to provide rebates, to all of the affected clients of the full amount they were overcharged, including the amount State Street UK's TM business overcharged Client F on the European trades. State Street UK's communications with one client did not properly explain the misrepresentations made to it, or that it had been overcharged, until late in 2013, more than a year after the completion of the Skilled Person's report. As a result, although State Street UK has agreed to compensate that client for detriment suffered as a result of failings in the UK TM business, there are on-going discussions as to the appropriate rebate amounts in relation to that client. State Street UK has agreed to conduct further work with the oversight of the Authority to confirm that the issue described at paragraph 4.60 above is an isolated issue.

Systems and controls

4.81. There was a lack of formality in the control environment around the UK TM business. Of most significance, there was no independent reconciliation of final commissions recorded in State Street UK's books and records and those disclosed in the final client reporting, back to the contractually agreed client charges per the legal documentation, or to the fees agreed in email correspondence.

4.82. Further, the following specific issues were identified in connection with the UK TM control environment in the Relevant Period:

(1) Contractual documentation – the UK TM business did not consistently comply with State Street UK's policy concerning the review and sign-off of legal agreements (including TMAs) and transition notices by Legal. There were no specific procedures or controls in place during the Relevant Period to prevent or detect this circumvention of this policy. Consequently, the contractual documentation was in some cases poorly drafted and lacked clarity, and the basis for charging was misleading or unclear in certain instances. In some cases there was a complete absence of fee information in the contractual

documentation; fees were sometimes communicated to clients by email. In other cases, some of the contractual documentation was informal and unsigned;

(2) Trading instructions – verbal communication between the TM desk and the PSG trade execution desks meant that trading instructions were not consistently documented or recorded;

(3) Manual booking of trades – for the majority of the Relevant Period, the TM team relied on manual processes and spreadsheets for managing and booking out transition trades which meant that it was possible for them to be manually adjusted. Accordingly, there was a risk that they could be manipulated;

(4) Segregation of duties - there was an absence of any segregation of duties which meant that front-office staff were able to enter, amend and verify TM trading commissions without an independent secondary review; and

(5) Client reporting – the client reporting process (both pre and post-trade) was manual and there were no clear protocols in relation to the calculation of costs and their allocation to various explicit and implicit costs lines in the client reports. In particular, there was no requirement in the TM desk policy for transition managers to fully disclose commissions or mark-ups separately from the bid-ask spread cost category in post-trade reporting. Instead, it was at the discretion of the transition manager whether fixed income mark-ups were shown separately. There was a lack of documented secondary review of client reports.

4.83. Separately, State Street UK did not have a comprehensive set of policies and procedures setting out the correct procedure for recording, approving, monitoring and reporting of all types of rebates. Accordingly, there was a risk that client rebates would not be recorded appropriately and/or brought to the attention of Compliance or State Street UK senior management.

4.84. As set out in paragraph 4.4 above, the matrix management framework in place at State Street in the Relevant Period operated in a way which meant that State Street UK senior management had only a secondary role in the day to day management of the UK TM business. As a result, State Street UK allowed business practices to develop in its UK TM business whereby acting in the client's interests was less of a priority than profit making.

Compliance

4.85. Compliance had responsibility for oversight of the compliance of EMEA PSG (and therefore State Street UK's TM business) with applicable regulatory requirements during the Relevant Period. This was achieved through the presence of business aligned compliance officers with identified responsibility for EMEA PSG, and through the implementation of an annual Compliance Monitoring and Testing programme.

4.86. Although Compliance was situated on the same floor as TM, Compliance was not considered particularly visible by those working in the UK TM business; it was considered peripheral and was not embedded into the business.

4.87. The adequacy of Compliance resourcing was a standing Key Risk Indicator reported to the monthly UK Risk and Compliance Committee meetings and was reported as both Red and Amber for a number of months in the Relevant Period.

4.88. The business aligned compliance officers were part of the Advisory team within Compliance and they were tasked with providing ongoing compliance advisory support and guidance to their respective business units. Despite this, Compliance was not informed by anyone from EMEA PSG or elsewhere within State Street about the overcharging.

4.89. The annual Compliance Monitoring and Testing programme failed to identify any of the control issues in respect of the UK TM business that existed in the Relevant Period. It was carried out on a thematic basis. There was no end-to-end testing of processes and controls within the SSGM businesses, including TM, in the Relevant Period.

Legal

4.90. Legal resource supporting State Street UK was known to be stretched at the time and, although arrangements were made to put cover in place, Legal was unaware that the UK TM business was entering into agreements which had not been reviewed by and cleared with Legal under applicable policies, and that contractual documentation was being used by the UK TM business which was in some cases poorly drafted and lacked clarity. As Legal was not closely involved in the UK TM business during the Relevant Period, Legal was unable to prevent or detect the overcharging.

Audit

4.91. SSGM's Corporate Audit Function was based in Boston and had responsibility for internal audit oversight of the UK TM business. Two audits of the UK TM business were undertaken in the Relevant Period. The first covered PSG front office arrangements, while the second covered the operational functions supporting PSG. Although the audits identified some control issues (for example the manual nature of the fixed income processes), they did not identify a number of the weaknesses that existed in the Relevant Period. Both audits received a satisfactory rating.

Risk

4.92. Whilst the Risk Management function identified some control weaknesses in the UK TM business, including concerns surrounding the accuracy and timeliness of client reporting in the Relevant Period, they did not identify the operational control weaknesses which existed during the Relevant Period, such as the lack of adequate processes overseeing the correct application of commission rates and spreads for TM trading.

5. FAILINGS

5.1. The statutory and regulatory provisions relevant to this Final Notice are referred to in Annex A.

Principle 6

5.2. **Principle 6 states:**

A firm must pay due regard to the interests of its customers and treat them fairly.

5.3. By reason of the facts and matters set out below, the Authority considers that State Street UK failed to pay due regard to the interests of its customers and treat them fairly, in breach of Principle 6:

(1) State Street UK allowed a culture to develop in its UK TM business in which the interests of customers were subordinated to the generation of revenue for the firm;

(2) In order to meet revenue targets State Street UK's TM business initiated and executed a deliberate and targeted strategy to overcharge certain UK TM clients and to conceal those charges from such clients. Between 1 June 2010 and 30 September 2011, State Street UK's TM business overcharged six of its clients, illegitimately earning $20,169,603. The strategy was primarily

executed by EMEA PSG senior management, but it was also carried out by members of EMEA PSG management and it had the full support of, and was enabled by, Global PSG senior management. Further, other more junior staff in the UK TM business and Finance enabled the overcharging to take place and failed to raise any concerns; and

(3) State Street UK exposed its TM customers to this overcharging because it failed to identify or manage the risk that this would occur. This failure arose because of the serious deficiencies in its business controls and control functions in relation to the UK TM business, and the inherent weaknesses in its governance and matrix management oversight framework throughout the Relevant Period.

Principle 7

5.4. Principle 7 states:

A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

5.5. By reason of the facts and matters set out below, the Authority considers that State Street UK failed to pay due regard to the information needs of its TM clients and communicated with those clients in a way which was unclear, unfair and misleading, in breach of Principle 7:

(1) State Street UK allowed its UK TM business to repeatedly provide certain TM clients with inaccurate, unclear and misleading information, at all stages of the transition process, as to the remuneration State Street UK would earn on transitions, and the charges and fees that would be levied, in order to conceal these from clients;

(2) State Street UK allowed its UK TM business to falsely hold itself out to two of the affected clients as complying with the Principles of the T-Charter, which it was aware was likely to be a material consideration for those customers in deciding whether to appoint it for the transitions, and then failed to comply with the T-Charter; and

(3) When Client F identified that mark-ups had been made to its US trades that had not been agreed, State Street UK's TM business deliberately failed to disclose to Client F the existence of further mark-ups on other trades conducted as part of the same transition.

Principle 3

5.6. Principle 3 states:

A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

5.7. By reason of the facts and matters set out below, the Authority considers that State Street UK failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, in breach of Principle 3.

5.8. There were significant failings in the business controls relating to the UK TM business. In particular, State Street UK failed to put in place appropriate systems and controls around its UK TM business to adequately mitigate the risk that employees would mislead and/or overcharge clients, and if such conduct occurred, to detect it in a timely manner. The systemic weaknesses in State Street UK's control environment around its UK TM business were so serious that the overcharging remained undetected throughout the Relevant Period until it was identified by a client.

Governance

5.9. The matrix management framework in place at State Street in the Relevant Period operated in a way which meant that State Street UK senior management had only a secondary role in the day to day management of the UK TM business. EMEA PSG senior management primarily agreed strategy and approach with Global PSG senior management, and conducted business with clients without sign-off and with little scrutiny from State Street UK senior management. As a result, State Street UK allowed business practices to develop in its UK TM business whereby acting in the client's interests was less of a priority than profit making. Further, State Street UK did not recognise that a culture had developed in its UK TM business which subordinated the interests of clients to the generation of revenue for the firm and did not identify the very serious misconduct within the UK TM business.

5.10. The level of discussion, scrutiny and challenge in relation to the UK TM business and its revenue streams in key State Street UK senior management meetings, including those of the UK Board, UK ExCo and SMC, was inadequate during the Relevant Period.

Business controls

5.11. The following key failings were specifically identified or reflected in the section 166 report. The Authority considers that these failings existed throughout the Relevant Period and that they constitute a breach of Principle 3:

(1) The fundamental control failing which enabled the overcharging to take place was a lack of independent reconciliation of final commissions recorded in State Street UK's books and records, as well as those disclosed in the final client reporting, back to the contractually agreed client charges as per the legal documentation (or to emails or other documents where fee agreements had been recorded);

(2) The UK TM business did not consistently comply with State Street UK's policy concerning the review and sign-off of legal agreements (including TMAs) and transition notices by Legal. Consequently, in many cases, the contractual documentation was poorly drafted and lacked clarity, and the contractually agreed basis for charging was misleading or unclear in many instances;

(3) The absence of any segregation of duties enabled front-office staff to enter, amend and verify TM trading commissions without an independent secondary review. The fact that commissions could be altered manually led to the risk that they would be inappropriately manipulated;

(4) The client reporting process (both pre and post-trade) was manual and there were no clear protocols in relation to the calculation of costs and their allocation to various explicit and implicit costs lines in the client reports. In particular, there was no requirement in the TM desk policy for transition managers to fully disclose commissions or mark-ups separately from the bid-ask spread cost category in post-trade reporting. Instead, it was at the discretion of the transition manager whether fixed income mark-ups were shown separately;

(5) There was a lack of documented secondary review (incorporating a check back to the underlying contractual terms) of client reports prior to the report being sent to the client which increased the risk that they would contain errors; and

(6) State Street UK did not have a comprehensive set of policies and procedures setting out the correct procedure for recording, approving, monitoring and reporting of all types of rebates. This exposed the business to an increased

risk that the procedures could be circumvented and rebates could be made to clients without scrutiny. As a result, members of PSG senior management were able to circumvent the usual processes to make a partial rebate to Client F in an effort to avoid detection by Compliance and State Street UK senior management.

Control Functions

5.12. The Compliance function failed to embed itself into State Street UK's TM business, and was known to be under resourced in the Relevant Period. The Authority considers that the lack of a compliance culture within the UK TM business was a key factor in why staff did not escalate any concerns to Compliance.

5.13. The Compliance Monitoring and Testing programme undertaken in relation to EMEA PSG (including the UK TM business) was wholly inadequate in the Relevant Period as it did not perform end to end testing of the risks and controls within the business but focussed instead on carrying out testing on a thematic basis. Consequently, Compliance failed to prevent or detect any of the numerous, serious failings relating to the UK TM business.

5.14. Neither the Corporate Audit function nor Risk Management identified the critical control failings that permitted the over-charging to take place and remain undetected.

5.15. Legal resource supporting State Street UK was known to be stretched at the time and, although arrangements were made to put cover in place, Legal was unaware that the UK TM business was entering into agreements which had not been reviewed by and cleared with Legal under applicable policies, and that contractual documentation was being used by the UK TM business which was in some cases poorly drafted and lacked clarity. As Legal was not closely involved in the UK TM business during the Relevant Period, Legal was unable to prevent or detect the overcharging.

5.16. There was a specific failure by Compliance to carry out an appropriate investigation into the Client F overcharging incident. In particular, Compliance did not take sufficient steps to confirm representations made to them by the EMEA PSG senior management before preparing a letter to Client F. They did not, for example, review the full transition file, client reports and legal agreements, or speak to others involved in executing the transition so as to understand what had occurred and satisfy themselves as to the appropriate terms of the letter.

6. SANCTION

6.1. The Authority's policy for determining a financial penalty is set out in Chapter 6 of DEPP which is part of the Authority Handbook. The Authority's current penalty regime applies to breaches which took place on or after 6 March 2010.

6.2. State Street UK's misconduct took place both before and after 6 March 2010. However, as a significant majority of the Relevant Period falls after 6 March 2010, and given that the overcharging of clients by the UK TM business, took place after 6 March 2010, the Authority has determined the appropriate financial penalty pursuant to the framework set out in DEPP 6.5A (as set out below).

6.3. In deciding the penalty, the Authority has had regard to all the circumstances of the case and the financial resources of State Street UK.

6.4. The Authority considers it appropriate in the particular circumstances of this case to impose a combined financial penalty for the Principle 6, Principle 7 and Principle 3 breaches.

Step 1: Disgorgement

6.5. Pursuant to DEPP 6.5A.1G, at Step 1 the Authority seeks to deprive a firm of the financial benefit derived directly from the breach.

6.6. As set out in section 4 of this Notice, State Street UK's TM business deliberately overcharged a number of its TM clients during the Relevant Period and as a result made a profit of $20,169,603.

6.7. As State Street UK has fully rebated, or offered to rebate, Clients A to F the full amount that they were overcharged, the Step 1 figure is nil.

Step 2: Seriousness and impact of the breach

6.8. The nature of TM is such that various of State Street's UK entities are involved in facilitating the transition process and generate revenue from the transitions. The Authority considers that the total revenue generated by State Street in connection with the UK TM business in the Relevant Period is the appropriate indicator of harm.

6.9. The relevant revenue is therefore the total revenue generated by State Street's UK entities in connection with the UK TM business during the Relevant Period, which is £49,534,679[1] ($77,904,287).

6.10. The Authority considers the breaches in this case to be particularly serious for the following reasons:

(1) State Street UK's failings allowed a culture to develop in the UK TM business which prioritised revenue generation over the interests of customers. As a result, the UK TM business developed and executed a deliberate and targeted strategy to overcharge certain TM clients;

(2) Six TM clients were significantly overcharged a total of $20,169,603;

(3) State Street UK's TM clients over the Relevant Period included large investment management firms and asset owners holding the pension money and investments of retail customers. Accordingly, State Street UK's actions in the wholesale market caused a risk of serious detriment to retail investors;

(4) In carrying out TM services for its clients, State Street UK acted as agent, and held itself out as being a trusted advisor. In one of the relevant transition agreements, State Street UK agreed to act as a fiduciary. Accordingly, State Street UK breached a position of trust;

(5) State Street UK's breaches revealed systemic weaknesses in State Street UK's systems and controls around their UK TM business;

(6) Further, the systemic weaknesses in State Street UK's control environment around the UK TM business were so serious that the overcharging was able to remain undetected until it was highlighted by a client. Had Client F not identified the mark-ups on its trades, the overcharging of clients may have remained undetected and further clients may have been overcharged; and

(7) State Street UK's breaches caused a significant risk that financial crime would be facilitated.

[1] The conversion to GBP was calculated using the average yearly or part yearly exchange rate applicable to each calendar year (2010/2011).

6.11. Taking into account the above factors, the Authority considers the seriousness of the breaches to be Level 5. Therefore, the Step 2 figure is 20% of £49,534,679.

6.12. The Step 2 figure is £9,906,936.

Step 3: Mitigating and aggravating factors

6.13. The Authority considers that the following are relevant aggravating and mitigating factors:

Aggravating factors

(1) It was only upon the instruction of a third-party analyst, and the completion of the internal and external investigations (including the investigation by the Skilled Person), that the extent of the overcharging against the TM clients was uncovered; and

(2) Although State Street UK has contacted the affected clients and has provided rebates or offered to provide rebates to all affected clients, State Street UK's communications with one client did not fully explain the misrepresentations made to it, or that it had been overcharged, until late in 2013, more than a year after the completion of the Skilled Person's report. As a result, there are on-going discussions as to the appropriate rebate amounts to one client.

(3) Despite the numerous investigations conducted since the overcharging came to light, the fact that a State Street entity had on one transition traded Fx without first having sought the client's permission and concealed this fact from the client was only identified by State Street UK in January 2014.

Mitigating factors

(4) The Authority acknowledges that State Street UK implemented a comprehensive remediation programme, at its own initiative, to resolve the overcharging issues that arose in the UK TM business. This included a structured programme to implement the control enhancements and other recommendations set out in the Skilled Person's report. Further, State Street UK established and resourced a central function to review and make improvements to the controls and culture across all of its UK businesses, not only the UK TM business. State Street UK has also bolstered its control functions in terms of both the quality and quantity of the staff and has made several new senior level appointments within its control functions.

6.14. Having taken into account the aggravating and mitigating factors set out above, the Authority considers that of the Step 2 figure should be increased by 10%.

6.15. The Step 3 figure is therefore £10,897,629.

Step 4: Adjustment for deterrence

6.16. The Authority considers that DEPP 6.5A.4(1)(a) is relevant in this instance and has therefore determined that this is an appropriate case where an adjustment for deterrence is necessary.

6.17. Without an adjustment for deterrence, the financial penalty would be £10,897,629. The Authority considers that a penalty of this size would not serve as a real credible deterrent as it is less than the amount of revenue generated by State Street UK from overcharging its TM clients. Given the size and stature of State Street UK, and the egregious nature of the misconduct, it is necessary for the Authority to increase the penalty to achieve credible deterrence.

6.18. Having taken into account the factors outlined at DEPP 6.5A.4G the Authority considers that a multiplier of 3 should be applied at Step 4. Therefore, the Step 4 figure is £32,692,888.

Step 5: Settlement discount

6.19. Pursuant to DEPP 6.5A.5G, if the Authority and the firm on whom a penalty is to be imposed agree the amount of the financial penalty and other terms, DEPP 6.7 provides that the amount of the financial penalty which might otherwise have been payable will be reduced to reflect the stage at which the Authority and the firm reached agreement. The settlement discount does not apply to the disgorgement of any benefit calculated at Step 1. The Authority and State Street UK reached agreement at Stage 1 and so a 30% discount applies to the Step 4 figure.

6.20. The Step 5 figure is £22,885,000 (rounded down to the nearest £100).

Penalty

6.21. The Authority therefore proposes to impose a total financial penalty of £22,885,000 on State Street UK for the breaches set out in this notice.

7. PROCEDURAL MATTERS

Decision maker

7.1. The decision which gave rise to the obligation to give this Notice was made by the Settlement Decision Makers.

7.2. This Final Notice is given under, and in accordance with, section 390 of the Act.

Manner of and time for Payment

7.3. The financial penalty must be paid in full by State Street UK to the Authority by no later than Thursday 13 2014, 14 days from the date of the Final Notice.

If the financial penalty is not paid

7.4. If all or any of the financial penalty is outstanding on Friday 14 2014, the Authority may recover the outstanding amount as a debt owed by State Street UK and due to the Authority.

Publicity

7.5. Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the Authority must publish such information about the matter to which this notice relates as the Authority considers appropriate. The information may be published in such manner as the Authority considers appropriate. However, the Authority may not publish information if such publication would, in the opinion of the Authority, be unfair to you or prejudicial to the interests of consumers or detrimental to the stability of the UK financial system.

7.6. The Authority intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

Authority contacts

7.7. For more information concerning this matter generally, contact Clare McMullen, Kerri Scott or Meg Gardiner at the Authority (on 020 7066 1000).

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Matthew Nunan

Head of Wholesale Enforcement

Financial Conduct Authority, Enforcement and Financial Crime Division

ANNEX A

RELEVANT STATUTORY PROVISIONS, REGULATORY REQUIREMENTS AND AUTHORITY GUIDANCE

1. STATUTORY PROVISIONS

1.1. The Authority's strategic objective, set out in section 1B(2) of the Act, is ensuring that the relevant markets function well. This is supported by three operational objectives which are;

1.1.1. The consumer protection objective;

1.1.2. The integrity objective;

1.1.3. The competition objective.

1.2. Section 206 of the Act provides that if the Authority considers that an authorised person has contravened a requirement imposed on him by or under the Act, it may impose on him a penalty, in respect of the contravention, of such an amount as it considers appropriate.

1.3. The Firm is an authorised person for the purposes of section 206 of the Act.

2. REGULATORY PROVISIONS

2.1. In exercising its power to issue a financial penalty, the Authority must have regard to the relevant provisions in the Handbook of rules and guidance (the "Handbook").

2.2. In deciding on the action proposed, the Authority has also had regard to guidance published in the Authority Handbook and set out in the Regulatory Guides, in particular the Decision Procedure and Penalties Manual ("DEPP") and the Enforcement Guide ("EG").

3. PRINCIPLES FOR BUSINESSES (PRIN)

3.1. The Principles are a general statement of the fundamental obligations of firms under the regulatory system and are set out in the Handbook. They derive their

authority from the rule-making powers as set out in the Act and reflect the Authority's regulatory objectives.

3.1.1 The relevant Principles are as follows:

Principle 6 provides: *"A firm must pay due regard to the interests of its customers and treat them fairly."*

Principle 7 provides: *"A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading."*

Principle 3 provides: *"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems"*.

4 ENFORCEMENT GUIDE (EG)

4.1 The Authority's approach to taking disciplinary action is set out in Chapter 2 of EG. The Authority's approach to financial penalties and public censures is set out in Chapter 7 of EG. EG 7.1 states that the effective and proportionate use of the Authority's powers to enforce the requirements of the Act, the rules and the Statements of Principles for Approved Persons will play an important role in the Authority's pursuit of its regulatory objectives. Imposing financial penalties and public censures shows that the Authority is upholding regulatory standards and helps to maintain market confidence and deter financial crime. An increased public awareness of regulatory standards also contributes to the protection of consumers.

5 DECISION, PROCEDURE AND PENALTIES MANUAL (DEPP)

5.1 Guidance on the imposition and amount of penalties is set out in Chapter 6 of DEPP. Changes to DEPP were introduced on 6 March 2010. As a significant majority of the Relevant Period falls after 6 March 2010, and as the Authority considers the overcharging of clients, which took place after 6 March 2010, to be the gravamen of the misconduct, it has determined the appropriate financial penalty pursuant to the framework set out in DEPP 6.5A.