

**MEMO# 31883**

August 2, 2019

# **SEC Sanctions Custodial Bank for Overcharging Mutual Funds for Custody Expenses**

[31883]

August 2, 2019 TO: Bank, Trust and Retirement Advisory Committee  
Chief Compliance Officer Committee  
Chief Risk Officer Committee  
Internal Audit Committee  
Operations Committee RE: SEC Sanctions Custodial Bank for Overcharging Mutual Funds for Custody Expenses

The SEC recently sanctioned a custodial bank for overcharging mutual funds and other registered investment companies for expenses related to the bank's custody of client assets.[\[1\]](#) The sanctions consisted of a cease and desist order and an order to pay disgorgement, prejudgment interest, and a civil monetary penalty of \$88,780,861. These sanctions were imposed based on findings that, from 1998 to 2015, the Respondent violated the anti-fraud and recordkeeping provisions of the Investment Company Act (ICA) by overcharging its investment company clients more than \$170 million for the custodial services. Most of these overcharges related to fees the Respondent charged for SWIFT messages.[\[2\]](#)

## **The Undisclosed Excessive SWIFT Charges**

With respect to the SWIFT charges, the Order found that the Respondent overcharged approximately 5,000 investment company clients over \$110 million for such charges. Pursuant to the Respondent's agreements with its custodial clients, the clients paid the Respondent for custodial services in the form of a fee based on a percentage of the client's assets, transaction charges at specified dollar amounts, and "out-of-pocket" expenses that reimbursed the Respondent for items it paid on behalf of the client and that were reimbursable to the Respondent as custodian. According to the Order, instead of billing clients for the current amount of these reimbursable expenses, the Respondent, instead, overbilled clients by approximately \$170 million. Most of this amount (\$110 million) related to outbound SWIFT messages.[\[3\]](#) As explained in the Order, the Respondent billed its clients a single amount for the SWIFT messages. This single fee had two components that were not broken down for clients. The first component was a "unit cost," which varied over time and by message type but typically ranged from \$.02-\$.15 per message unit.[\[4\]](#) The second component was a fee of \$5.00 per message.

While the amount of the SWIFT fee should have equaled the amount necessary to reimburse the Respondent, the SEC found that, instead, the Respondent tacked on a “margin” without disclosing this margin to clients. As early as 2002, the Respondent was aware that its billing for the SWIFT charges exceed its SWIFT-related expenses. In 2009, this \$5.00 charge was reduced to \$.25, *but only to new clients or to clients that had not previously been charged for SWIFT.*<sup>[5]</sup> In 2010, when the Respondent developed a standard fee schedule template to be used for contracts with custody clients, the SWIFT fee was adjusted, but

. . . rather than correcting the issue for all clients, [the Respondent] continued to revisit the SWIFT rate in response to specific clients’ requests or during contract negotiations. In at least one instance thereafter, in late 2015, [the Respondent] secured a contract renewal with an existing client by offering to reduce the client’s SWIFT costs going forward, without disclosing to the client that [the Respondent] had overcharged the clients for SWIFT for years.<sup>[6]</sup>

The SEC found the Respondent violated the anti-fraud provisions of the ICA by engaging in this undisclosed overcharging.

## **The Recordkeeping Violations**

As noted above, the Respondent was also charged with violations of the recordkeeping requirements under the ICA – *i.e.*, Section 31(a) and Rule 31a-1(a).<sup>[7]</sup> The Order notes that, in its role as custodian for registered investment companies, “from at least 1998 into 2015, [the Respondent] maintained records for [registered investment companies] showing inflated rates for certain out-of-pocket expenses.”<sup>[8]</sup> The investment companies that were overcharged included, in addition to the Respondent’s custodial clients, clients that had contracted with the Respondent for accounting services. This later group of clients relied upon the Respondent to maintain journals that included fund expenses, calculated fixed and variable expenses, and calculated expense caps and expense reimbursement that were relied upon by the clients. This conduct resulted in violations of the recordkeeping requirements.

## **The Respondent’s Self-Reporting and Remedial Measures**

The Order notes that, in imposing sanctions on the Respondent, the SEC took into account that the Respondent had: self-reported its conduct to the SEC; provided the Commission staff “substantial cooperation” in the SEC’s investigation; “promptly announced that it would reimburse its custodial clients for the amounts that it determined were in excess of its costs, with interest;” and taken several remedial steps to address the violations and their causes.<sup>[9]</sup> It also engaged a consulting firm with financial and forensic accounting experience to assess the Respondent’s processes to identify the categories of expenses that were overbilled, to identify affected clients, and assessment the Respondent’s method of calculating the amount of client reimbursements.

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## endnotes

[1] See *In the Matter of State Street Bank and Trust Company, Respondent*, SEC Release No. 33534 (June 27, 2019) (the “Order”), which is available at: <https://www.sec.gov/litigation/admin/2019/ic-33534.pdf>. The SEC’s press release regarding this matter is available at: <https://www.sec.gov/news/press-release/2019-114>.

[2] SWIFT refers to the Society of Worldwide Interbank Financial Telecommunications which operates a secured messaging network used by banks and other financial institutions.

[3] The remainder of the overcharges involved: (1) asset pricing and valuation services from third-party vendors; (2) SAS 99 data feeds; (3) SOC-1 reports; and (4) preparation of Rule 17f-5 reports relating to foreign sub-custodial arrangements.

[4] The Order notes that a single SWIFT message might contain multiple message units.

[5] Order at p. 4.

[6] *Id.*

[7] These provisions require each registered investment company to maintain and keep current the accounts, book, and other documents forming the basis for the company’s required financial statements.

[8] Order at p. 5.

[9] Order at p. 6.