

WALL STREET

Prosecutors Are Not Amused by Hidden Trading Markups



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By [Matt Levine](#)

The financial industry is largely an industry of middlemen, and some of its deepest and most creative thinking goes into finding ways to get paid for intermediating transactions. There are two classic, time-honored, traditional ways to get paid:

1. *Markups*, or *spreads*: I buy a thing from someone for \$60, sell it to you at \$65, and pocket the \$5.
2. *Commissions*: I sell a thing to you at \$65, and charge you \$1 for my trouble.

But of course there are lots of other ways to get paid, too; the only limit is my imagination, and also probably the law. For instance, I could lend you the \$65 to buy the thing and charge you interest. I could keep custody of the thing and lend it out to short sellers, charging them fees that I don't pass on to you. I could pass your order to an electronic market-maker who pays me for your order flow. I could charge you an annual fee for managing your thing-purchasing program, or for sending you research reports about things.

Most notably, I can get paid in *more than one* of these ways. Just because I have charged you a markup doesn't necessarily mean that I can't also charge you a commission, or an annual fee, or whatever. Now, maybe in practice I can't: Different markets and jurisdictions have different rules about fees and markups and disclosure, and I certainly don't want to give you legal advice. But as a bare conceptual matter, there is nothing necessarily illegitimate about making money off of a customer in more than one way. *** If you buy foreign currency at the airport, or stocks from a broker, you may well pay both a bid-ask spread and a commission. ***

That is lovely for me, but rather daunting for you. You don't want to pay twice, or four times, for the same thing. You want to know how much I am making off the transaction, so you can decide if I'm worth what you're paying. So you can ask me what I'm charging. But you have to phrase the question carefully. If you pay me an annual fee, and you ask me if I'm also charging commissions, I can answer "no," and chuckle to myself about the markups I am charging. If you ask about

markups, I can again answer "no," and chuckle even more quietly about the payment for order flow that I am receiving. But perhaps you have given this a lot of thought, and you ask me something comprehensive and unavoidable, like "please confirm that this fee is the sole revenue for your firm and/or any of its affiliates on this event." And then I will be stuck.

Unless I cheat! Today federal prosecutors [unveiled criminal fraud charges](#) against two former State Street employees, Ross McLellan and Edward Pennings, for allegedly going a bit too far in hiding fees from clients. We [talked about this case](#) two years ago, when State Street [settled with](#) the U.K. Financial Conduct Authority for a 22.9-million-pound (\$32.4 million) fine for the transactions at issue here. The U.S. authorities, I guess, moved more slowly -- but they brought *criminal* charges instead of settling for a fine.

According to [the indictment](#), McLellan and Pennings worked in State Street's transition management business, which does very large and boring transactions for institutional investors in exchange for very small and boring fees. *** I mean, the fees are very small relative to the size of the transactions, and boring in the sense that that they are often a flat percentage of the assets involved: In the three transactions described in the indictment, State Street's fees ranged from zero to 1.75 basis points of assets.

Now, while 1.75 basis points of a 1.3 billion-pound transaction is real money -- 227,500 pounds -- it is not, perhaps, enough to motivate an executive vice president and a senior managing director of an international financial-services business. Also, zero basis points of any transaction is zero dollars, which is rarely enough to motivate anyone. So McLellan and Pennings allegedly got to work adding other fees to their transactions, to make them worth their while.

Some of this was easy. On that zero-basis-point deal, with a Middle Eastern sovereign wealth fund, McLellan and an unnamed co-conspirator ("CC-1") could just silently charge markups on the prices they provided to the customer:

In a telephone call among CC-1, in London, and two Boston-based traders on or about June 15, 2010, CC-1 instructed the traders that "before you book out the client side, send the executions across and we will have a look and figure out what levels we want to put on the client side." On the same day, MCLELLAN, who was in London at the time, asked one of the traders for "the range [of prices] across the day ... " adding, "Basically, I want the high."

That is: If a bond traded between \$100 and \$102 in a day, and State Street bought that bond for the Middle Eastern customer that day, then the customer paid \$102 for it -- whatever State Street paid. Pennings allegedly told the co-conspirator that McLellan had told him, "it's a rounding error, so no one is ever going to notice that."

I guess that is bad, but on the other hand, how much loyalty did the sovereign wealth fund think it was buying for zero dollars? *** The second trade, with an Irish government pension fund, also

allegedly snuck in some extra charges, *** but you can just about see a defense in the indictment itself. Here's the deal:

The Bank ultimately proposed a flat management fee of 1.25 basis points (0.0125%) of the value of the transitioned assets. The proposal specified that there would be no fixed income or equities commissions.

("The extra quarter point makes it look like we actually thought about it and did the calculations," Pennings said in an e-mail.) But that word "commissions" is subject to interpretation, and State Street interpreted:

In a subsequent telephone call, PENNINGS told CC-1 that "we just need to be very, very creative, which we will," and added: "Make sure it ... doesn't say anything about not taking any spreads, because we're going to have to in the U.S."

The grand jury apparently disagreed, but I interpret this to mean that State Street promised not to add *commissions*, but did *not* promise anything about adding *markups*. In fact, according to the indictment, Pennings proposed a no-commission/yes-markup structure from the beginning, as State Street was preparing its bid for the Irish transaction:

In an email to MCLELLAN on or about December 1, 2010, PENNINGS wrote: "Gotta win this one! Any ideas how to get more revenue would be appreciated. ... How about a 1 [basis point] management fee or something of that nature, no commissions and then take a spread?"

And the documentation apparently reflected that: a fee (ultimately 1.65 basis points), no commissions, and ... well, I guess it didn't specifically allow State Street to take a spread, but it didn't specifically prohibit it either. ("Make sure it ... doesn't say anything about not taking any spreads.") And so State Street charged the customer a spread that, under the agreement, it was allowed -- or, at least, not prohibited -- from charging.

But the third case in the indictment is the troublesome one. This was a British government pension fund that agreed to pay State Street 1.75 basis points for a 1.3 billion-pound transaction. And this fund was a bit clearer-eyed about the ways in which it could be charged. Right from the beginning, when State Street answered the fund's request for proposal, there was trouble:

In its response to the RFP, the Bank proposed a flat fee of 1.75 basis points (0.0175%) of the value of the assets and promised to "provide full disclosure" of "all costs incurred in the transition and any additional revenue sources ... resulting from the transition."

That's not a term of art like "commissions"; that's "all costs" and "any additional revenue sources." That sounds like a promise of full disclosure. And then the fund really did demand full disclosure:

For example, in response to a June 21, 2011 email from an executive of the British Government Pension Fund requesting confirmation that "£242,305 (equal to 1.75 [basis

points] on the [assets under management] ... is the sole revenue for [the Bank] and/or any of its affiliates on this event," PENNINGGS responded: "Yes -- £242,305 (It should equal 1.75 [basis points] of the total assets)."

Yeah, once you are asked if the fee "is the sole revenue for [the Bank] and/or any of its affiliates," you really do have to come clean about any other stuff. Those are kind of the magic words. The British pension fund cracked the code; if Pennings was charging any other fees or markups or whatever else you want to call them, he really should have come clean. The indictment claims that he was, *** and that he didn't come clean.

But the British fund didn't just know the magic question to ask; it also knew how to check the answer:

When the fund executive informed PENNINGGS that auditors reviewing publicly available data had discovered what appeared to be a one basis point commission on all U.S. trades, PENNINGGS responded: "That doesn't seem right so let me investigate with the US desk and get back to you."

A lot of trading data is public! If the customer really wants to check to make sure that he's not being charged extra, often he can. It's just that part of the point of hiring a transition manager, and paying a negotiated fee, is to outsource this sort of administrative work. It's not, you might think, unreasonable for the customer to trust the manager. But that also means that it's not unreasonable for the manager to trust that the customer will trust him, and thus feel safe in adding a few markups here and there. (Especially when the customer is asleep -- as ConvergeEx [once literally did](#) in its transition-management business.) And so it turns out that the customer can't really trust the manager after all.

McLellan [denies any wrongdoing](#):

"The evidence will ultimately and compellingly show that Ross McLellan committed no criminal acts and had no criminal intent," his attorney, Martin G. Weinberg, said in a statement. "Every major bank charges its clients markups on its bond transactions in order to generate profits."

He no longer works at State Street; he is the founder and president of a firm called Harbor Analytics. You will never guess [what Harbor Analytics does](#):

Harbor Analytics is a leading provider of independent analytics on transition management events. Our Transition Management Scorecard™ evaluates the relative performance of any transition, the risk management of the transition provider, evaluates all trading for any compliance violations and compares each result against the largest independently audited transition management universe.

It isn't enough, McLellan understands, to just bid out a transition management event and go with the lowest bidder. You can't just blindly trust your transition manager; you need an independent

consultant to monitor the manager's performance and check for compliance violations. You don't want to be a sucker, to be tricked into paying extra markups by a transition manager who preys on your carelessness or ignorance. So you need to hire a consultant who knows all the tricks, to avoid having them played on you.

I have to say that that is a very traditional model in the financial industry. It's why a lot of former derivatives structurers end up [atoned for their sins](#) by helping clients avoid derivatives trickery. "Caveat emptor" is the motto, and clients who know the magic questions and audit the answers get better results than clients who sleepily put their trust in their brokers.

But it isn't the only model! You could imagine a financial industry with much stronger norms of trust and disclosure and forthright honesty, in which the general assumption is that if a broker doesn't mention a (fee/markup/whatever) specifically, that means that he *isn't* charging it, rather than that he probably is. And it's pretty clear that that is the model that U.S. prosecutors like to imagine. With prosecutions of [bond traders](#) who are arguably dishonest about their markups, and now with this prosecution of transition managers who allegedly hid theirs, the Justice Department is sending a message. It wants customers to be able to put more trust in their brokers. And if the customers fail to monitor and check up on their brokers, well, that's OK. The prosecutors will keep an eye on them too.

1. *Or even not disclosing all the ways I am making money, though here we get into murkier areas. Certainly if I **lie** to you about the ways I am making money, I am likely to get in trouble. And sometimes the line between lying and concealment can be hazy. This is, as always, not legal advice.*

Also, importantly, some middleman relationships -- particularly those with, say, annual fees -- tend to come with fiduciary duties. And if I am your fiduciary, I really ought to disclose all of my fees to you. But, again, there is nothing in the bare concepts of "middleman" and "fees" that requires a fiduciary relationship.

2. *Yes, I know, the retail stockbroker isn't technically charging you both the bid/ask and the commission. He's charging you a commission, and "the market" (a wholesaler) is charging you the bid/ask spread. But the wholesaler is quite possible paying the broker for your order flow, meaning that the broker is in a sense making money off the bid/ask spread as well as the commission.*

3. *From the indictment (paragraph 4):*

Large institutional investors --such as pension funds and endowments -- often have complex investments consisting of relatively illiquid assets, or positions that due to their sheer size are difficult to unwind without negatively affecting their price. Transition management is, generally, the business of helping such institutions efficiently move their investments between and among asset managers or liquidate large investment portfolios, with the goal of minimizing the costs associated with such "transitions." As a general matter, transition managers have three principal tasks: (1) to assume responsibility for the performance of investment portfolios during transitions; (2) to communicate with incoming and outgoing asset managers about the composition of their respective portfolios; and (3) to facilitate transitions by executing the necessary trades, with the goal of reducing risk and cost for their clients.

4. Here is a partial explanation, from paragraph 12 of the indictment:

In an email to a representative of the Middle Eastern Sovereign Wealth Fund -- which was one of the Bank's largest transition management clients -- PENNINGGS wrote: "We will price the bonds and t-bills at 'net' -- this means that for this transition there will be no commission charged on the fixed income trades. We anticipate being able to charge the other side of the transactions which will enable us to keep commissions for [the Middle Eastern Sovereign Wealth Fund] at zero."

I mean that is more or less a disclosure that they'll charge a spread, isn't it? It is phrased funny, but you can't "charge the other side." If you buy from one side at \$62, and sell to the other at \$63, then you have made a spread; it is silly to debate who you charged.

5. For instance (paragraph 26):

Because the Irish Government Pension Fund transition involved a significant amount of equities -- for which commissions were ordinarily broken out and reported automatically by the Bank's trading systems -- MCLELLAN, PENNINGGS, and others known and unknown to the Grand Jury devised a plan to conduct the trades in a special trading account ordinarily used to guarantee customers a specific price -- the volume weighted average price ("VWAP") -- of trades executed over the course of a day. Using the VWAP account, the Bank was able to include a commission of 2 basis points (0.02%) on each of the U.S. equities trades it executed for the Irish Government Pension Fund, without the commission being broken out on reports sent to the client.

6. For instance (paragraph 32):

Thereafter, at the direction of MCLELLAN, PENNINGGS, and CC-1, the Bank secretly applied commissions of one basis point (0.01%) to all U.S. trades, and 2 basis points (0.02%) to all European trades it conducted on behalf of the British Government Pension Fund, in addition to the agreed-upon flat fee. For example, on or about March 22, 2011, MCLELLAN instructed a U.S. fixed income trader to "take a basis point of yield" on trades for the British Government Pension Fund, notwithstanding that the written trading instructions issued by the transition manager said to charge zero commissions. Later that same day, MCLELLAN instructed the trader to delete any reference to commissions on the file of trading results he sent to the transition manager.

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