FX Litigation Roundup

January 2017

The foreign exchange market is the world's largest financial market, accounting for $5 trillion in *daily* trading volume. But unlike some of the more heavily-regulated securities markets, trading in the FX market can bring with it an element of the wild-wild-west.

Investigations into FX trading have come to cover a variety of associated activities, spanning benchmark manipulation, collusion to widen bid/offer spreads, front-running, stop-loss triggering, backing away from quotes, and suboptimal execution. Regulatory settlements and penalties have now surpassed $10 billion worldwide, while private actions have garnered over $2 billion in settlements. We will briefly examine each of these areas and the current status of the investigations or litigation.

Benchmark Manipulation

The WM/Reuters 4PM (London) Fix is the most widely referenced FX benchmark, with its construction being the original focal point of government investigations and private actions. This 4PM fix was regularly used to price and settle trillions of dollars' worth of currency transactions.

A corporation with revenues denominated in euros (EUR) may, for example, wish to convert them into Australian dollars (AUD). A common practice would be for that company to place an order with its dealer to transact on its behalf at that day's WM/Reuters 4PM fix.

Armed with advanced knowledge of their customers' pending orders heading into the 4PM fix, certain banks were found to have colluded to set the 4PM fix at levels most advantageous to the banks, at the expense of their customers.

Four banks – Barclays, Citigroup, JPMorgan, and RBS – entered guilty pleas with the Department of Justice (DOJ) in May 2015, paying fines totaling $2.52 billion. Those four banks and several others have also entered into settlements with financial market supervisors world-wide: US regulators CFTC ($1.875 billion), Federal Reserve ($1.847 billion), OCC ($950 million), and NY DFS ($485 million); UK's FCA ($2.372 billion); Swiss regulator FINMA ($139 million); and Australia's ACCC ($11 million).

The 4PM fix was calculated based on trades and quotes during a one-minute window from 3:59:30 to 4:00:30. Bank traders communicated with each other in electronic chat rooms – with names such as "The Cartel" and "The Mafia" – and were found, problematically, to have regularly shared customer order information.

According to the DOJ, the manipulation consisted of tactics such as the following:

- "agreeing to enter into non-bona fide trades among themselves on an electronic FX trading platform…."
- "agreeing to subsequently cancel these non-bona fide trades, or to offset them by entering into equivalent trades in the opposite direction…."
- "coordinating on the price, size, and timing of their bids and offers…."
- "agreeing to refrain from trading" when it suited one or more of the cartel members
- "coordinating their trading prior to and during fixes"
- "coordinating their trading in order to move pricing through their customers' limit order levels"[i]

These are among the charges the DOJ leveled against Jason Katz, a former FX trader at ANZ, Barclays, and BNP Paribas. In January 2017, Katz "pleaded guilty to participating in a price-fixing conspiracy in the FX market."[ii] A former Citigroup trader would also plead guilty to similar charges.[iii]

Some banks are accused of having tampered with other foreign exchange benchmarks too, including the ECB Fix, the CME daily settlement, and the Association of Banks in Singapore Malaysian Ringgit (ABS MYR) Fixing Rate. In December 2016, Australia's Federal Court imposed penalties against ANZ (approximately $7 million) and Macquarie (approximately $4 million) after the banks admitted to "attempted cartel conduct" in their daily submissions for the ABS MYR Fixing Rate.[iv]

In the US class action, plaintiffs have $2 billion in settlements in hand, with several defendants yet to settle. Similarly, in Canada, private action plaintiffs have reached $12 million in settlements. The cases are ongoing. US prosecutors have criminal charges outstanding against three former traders (from Barclays, Citigroup and JPMorgan Chase) who participated in FX rigging via "The Cartel" chat room, while two former traders have recently entered guilty pleas.

The US class action is In re Foreign Exchange Benchmark Rates Antitrust Litigation (13-cv-07789); the Canadian class action is Mancinelli et al v. Royal Bank of Canada et al (CV-15-536174CP). The criminal cases are US v. Usher (17-cr-00019), US v. Katz (17-cr-00003) and US v. Cummins (17-cr-00026).

Collusion on Bid-Offer Spreads

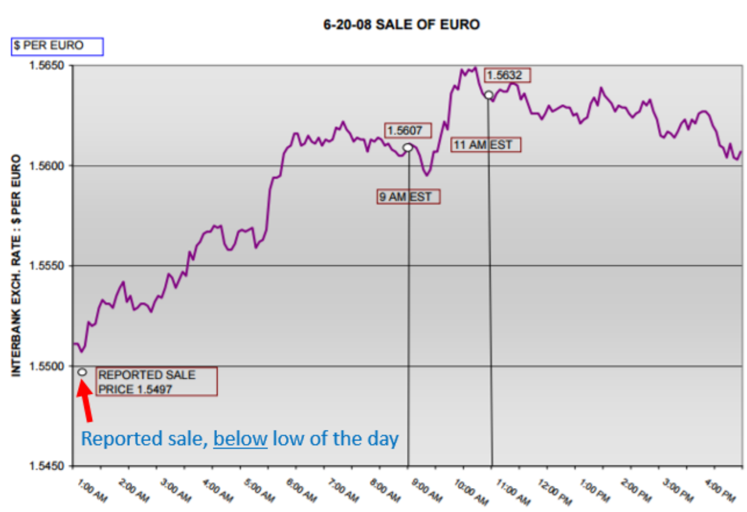
In addition to colluding on benchmark fixes, FX traders allegedly conspired to maintain wider bid-offer spreads, according to the benchmark class action complaint, although the chat room transcripts concerning bid-offer spread widenings are redacted. The complaint seeks to show that traders in the "Essex Express" chat room "discussed how they were going to reach out to other Defendants to keep the spread wider than it would be under competitive circumstances."[v] Wider bid-offer spreads help dealers earn higher trading revenues, at their customers' expense, since the customers often buy at the dealers' (now higher) offer rates and sell at the dealers' (now lower) bids.

Custodian Services and "Standing Instruction" Orders

The two largest custodian banks in the United States, Bank of New York Mellon (BNY) and State Street, settled allegations with regulators (DOJ, SEC, and Department of Labor) and class action plaintiffs that they frequently failed to fulfill their promises of *best execution*. BNY settled for a combined total of $714 million in March 2015;[vi] State Street settled for a combined total of $530 million in July 2016.[vii]

The allegations centered on transactions that the custodian banks executed on behalf of customers at the banks' discretion: so-called "standing instruction" or "non-negotiated" orders. Using these types of orders, customers would instruct their banks to transact for them that day, but would not specify the time or price of the transaction, leaving it up to the banks to deliver on their promises of best execution.

Plaintiffs in the BNY case alleged, based on a statistical sample, that BNY charged its clients a rate worse than the daily mid-point on more than two-thirds of transactions executed. Plaintiffs highlighted examples of the poor fills they were provided, including the following, in which the executed price provided lies below the lowest level of any trade entered that day.



Source: http://bnymellonforexsettlement.com/docs/Master_Customer_Class_Complaint.pdf (with aesthetic additions made)

By way of a frequency distribution of sampled transactions, separating trades into groups ranging from the worst exchange rates of the day to the best exchange rates of the day, plaintiffs sought to demonstrate that a full 17% of trades occurred at the worst rates of the day. The implication is that banks may have made a practice of looking back, at the end of the day, for the worst rate observed during the day (from the clients' perspectives) – and they passed that rate on to their clients. This would constitute an unfortunate version of hindsight trading.

The class actions referenced are In re Bank of New York Mellon Corp. Forex Transactions Litigation (12-md-02335), and Arkansas Teacher Retirement System v. State Street Corporation et al (1:11-cv-10230).

Front Running

The practice of trading ahead of a client's large order is believed by some to have been widespread in the FX market – and was not limited to the *front-running* of trades set to be executed at the benchmark fixing rates.

When a customer has a large order, the execution of that order itself may move the market. A dealer with knowledge of the forthcoming order can position itself ahead of the market-moving transaction to take advantage of the anticipated price move. The dealer could also exacerbate the price impact of the large order by trading in the same direction of the order, once positioned accordingly.

For example, suppose a client placed an order for its dealer to buy EURUSD (buy Euro, sell Dollar). The dealer could slowly accumulate a long position in EURUSD at lower prices, and then push the price up by buying aggressively just before executing the client's order at the new "market" level.

The DOJ has criminally charged two former HSBC traders with *front-running* a large corporate client's order. The DOJ alleges that, in December 2011, Mark Johnson (former head of global FX cash trading) and Stuart Scott (former head of FX cash trading for Europe, the Middle East and Africa) had knowledge of a large pending order and acted on that knowledge for their or the bank's benefit.

The DOJ has not revealed the identity of the damaged company, but it has been reported to be the British firm Cairn Energy PLC. Cairn Energy had sold an Indian subsidiary and was in the process of repatriating $3.5 billion in proceeds into its home currency, Pound Sterling.

According to the DOJ, Johnson and Scott persuaded the company to trade at the less liquid 3PM Fix time, which made it easier for Johnson and Scott to manipulate the exchange rate. They allegedly told the company that trading at the 4PM fix would expose the company to a higher risk of being front-run, saying, "Because people do look for that, for the significant flows to happen at 4 o'clock and once they get a smell of that or a smell of significant flow going through, they will try to jump in front and start to muck around in the markets."[viii]

Attuned to the company's forthcoming trading intentions, Johnson and Scott allegedly established a large long position in GBPUSD (Sterling/Dollar). Prior to the 3PM fix, at 2:56, they are said to have "ramped" up GBPUSD to a 2-day high, causing the company to pay more when converting its Dollars into Sterling. The DOJ estimates that HSBC made $8 million from *front-running* the trade.

HSBC employees are at the center of another DOJ inquiry, potentially having leaked confidential client information about a pending order to Moore Capital, a hedge fund client with over $50 billion in AUM. In March 2010, an HSBC employee reportedly leaked information to Moore Capital about the size and timing of UK insurer Prudential PLC's upcoming conversion of GBP to USD, part of Prudential's $35 billion acquisition of an Asian subsidiary of AIG. The trader purportedly warned Moore Capital against being caught up on the wrong side of, or trading into, a large currency movement.

An HSBC trader also reportedly sold GBP ahead of Prudential's transaction. On the day of the transaction, GBPUSD fell 3%. According to reports, HSBC later discovered the incident in the course of an internal investigation into potential FX wrongdoing, and self-reported the incident to US and UK authorities. We are unaware of any charges having been filed at this time.

Other banks, globally, have also been under surveillance for *front-running* their clients' orders.

The DOJ's 2015 Plea Agreement with RBS noted that "… in connection with the FX component of a single corporate transaction, RBS was guilty of trading ahead of a client transaction so as to artificially affect the price of a currency pair and generate revenue for the defendant, and to affect or attempt to affect FX rates, and in addition misrepresenting market conditions and trading to the client."[ix]

In November 2014, Swiss regulator FINMA concluded that several FX traders at UBS "engaged in front running and triggered client stop loss orders to the bank's advantage in order to maximize its profits."[x] FINMA's report contained excerpts from UBS trader group chats such as:

- *"I was front running EVERY single offer in usdjpy and eurjpy"*
- *"thanks vm my friend […] you can front run this as you like, up to you"*
- *"I was using my management book to front-run an order"*

In December 2016, the Australian Securities and Investments Commission (ASIC) cited National Australia Bank (NAB) traders in an Enforceable Undertaking for using customer order information, including from other banks, "in order to inform their joint personal trading strategy…."[xi] ASIC fined NAB and Commonwealth Bank of Australia (CBA) roughly $2 million each for their FX conduct.[xii]

Other indications of *front-running* come from a former Citigroup employee's suit against the bank for wrongful termination. According to the former FX trader, Perry Stimpson, Citigroup made $35 million front-running a client involved in a large M&A transaction.[xiii] Stimpson prevailed in his lawsuit against the bank and would say in a statement that "I took Citi to the court because I felt that I'd been singled out and made a scapegoat, when my actions were common across the bank and the industry as a whole."[xiv]

Stop-Loss Triggering

Somewhat akin to *front-running*, in that customers' trade information is used against them, dealers also allegedly engaged in conduct known as *stop-loss triggering*.

A stop-loss order is a customer order in which the customer specifies a price point at which he would like to exit his position, possibly to try to limit the losses that could result from an adverse price move, or to lock in gains from a favorable price move.

For example, if the customer is long EURUSD, he might have a stop-loss set at 1.0100. If EURUSD falls to or below 1.0100, his stop-loss would be triggered and it would become a market sell order.

A dealer looking to move the market in a given direction could harness the power of customer stop-loss orders and add to his firepower by triggering stop-losses. That is, the triggering of the stop-loss will add to the supply/demand in the market and further push the rate in the desired direction.

In one scenario, suppose the dealer has a financial interest in EURUSD declining well below 1.0100. If he quotes large enough offers or makes enough sales, he can move EURUSD to the customer's stop-loss level, even if only for a moment. Once the stop-loss level is breached, the customer's sell order is activated, which puts further downward pressure on the currency pair.

Another scenario would be for the dealer to simply use the stop-loss order to close his own position, if market prices are close to but have not yet reached the stop-loss level. In this situation, the dealer makes sales to establish a short position, say at 1.0120, 1.0110, and 1.0105. If the dealer can stay on the offer and hit enough bids to get the price down to the stop-loss level of 1.0100, then he will be able to cover his short when the stop-loss is triggered, at 1.0100 or possibly lower.

FINMA's report on UBS cited trader quotes discussing stop-loss triggering activity, such as:

- *"jamming some stops in eurusd here at 0515"*
- *"we just jammed a eurjpy stop"*

Meanwhile, ASIC cited the following exchange in an Enforceable Undertaking with Commonwealth Bank of Australia (CBA):

- *"got a tricky stop at 60, not big, but tricky"…"went long from 44 and kept buying smalls as is going up" "average is long at 52"… "had to buy 10 extra at 60 to get it done and sold those at 61"*[xv]

To elaborate on this quote, the CBA trader started accumulating a long position knowing that he could offload the position to the client at higher prices once he triggered the client's stop-loss. Dealers typically quote prices in "pips," as they are likely doing here, and are likely quoting just the last two digits of the four decimal places. The trader started buying at 44 and his average purchase cost was 52. He likely exited the position at 61 by selling to the client, who was forced to cover his short position when his stop-loss was triggered.

Barrier-Running

Like *front-running* and *stop-loss triggering*, *barrier-running* involves dealers taking advantage of their knowledge of customer information, generally pursuant to private contracts the customer would have entered with the dealer. With *barrier-running*, dealers attempt to "knock out" customers from their FX exotic options positions, or defend against barriers which would "knock in" and activate customers' options.

For example, suppose a customer has a long FX option position that gets terminated if a certain level, or "barrier" (agreed upon by customer and dealer), is reached. The dealer that wrote the option has downside risk as long as the barrier has not been touched, but he can eliminate that risk if he can move the referenced FX level, even just for a second, to or beyond the barrier level.

The issue also pertains to digital options, or binary options. The payoff at expiration, if in-the-money, is fixed; if out-of-the-money, the payoff is zero. If the dealer can move the market such that the option is out of the money at the time of expiration, even by only 0.0001, then he can avoid paying out potentially large sums to the option holder.

The primary consolidated complaint, filed mainly in regards to benchmark manipulation, includes the names of FX traders' electronic chat rooms through which they shared information, including one called "Barrier Killers."[xvi] The Bank of England, in its *Fair and Effective Markets Review* published in 2015, noted that "Deliberate attempts to manipulate an underlying instrument in order to influence the payout of an option should be considered unacceptable practice."[xvii]

According to *Euromoney*, "A former head of currency options at a global investment bank, who wished to remain anonymous, described barrier running as 'commonplace'"[xviii]

ADR Dividend Conversion

Foreign companies looking to tap the US capital markets often issue American Depositary Receipts (ADRs), a relatively simple process through which US investors can purchase shares in the foreign companies. Depositary banks, such as BNY, Citigroup and JPMorgan, facilitate the process on behalf of investors and the issuing corporations. When the corporation issues a dividend in its local currency, the depositary bank converts that cash flow into US dollars for deposit into investors' brokerage accounts.

Plaintiffs have sued the depositary banks, alleging that they converted the dividends at unfavorable foreign exchange rates, amounting in essence to the charging of undisclosed fees.

For example, Citigroup is accused of having "breached these contractual duties to Plaintiffs and Class members by charging Plaintiffs and the Class additional fees over and above those specified in the applicable contracts. It did this by assigning unfavorable exchange rates applied to the conversion of non-USD-based Cash Distributions by foreign companies prior to issuing those payments to ADR Holders. These rates reflected a spread between the exchange rate the Bank actually received at the time of the conversion and the rate Citi assigned its clients."

Similar to the allegations in the Citigroup complaint regarding execution rates, plaintiffs in the JPMorgan Chase case contend that: "Comparing the FX conversion rate that JPMorgan assigned to Cash Distribution conversions to the range of the interbank market on the day that the Cash Distributions were converted shows that ADR Holders received unfavorable FX conversion rates below the midpoint of the day's trading in 86% of conversions (362 of 419 transactions)."

The related cases are Carver et al v. Bank of New York Mellon et al, 1:15-cv-10180; Merryman et al v. JPMorgan Chase Bank, NA, 1:15-cv-09188; and Merryman et al v. Citigroup et al, 1:15-cv-09185.

"Last Look"

Another problematic practice in the FX market is the application of *Last Look*, whereby FX dealers back away from, or fail to honor, their live quotes to customers. This antiquated feature was originally designed to protect dealers from having to execute multiple orders on the same quote before they had a chance to update their quotes. In today's markets, dealers are generally able to rapidly update their quotes.

Regulators are concerned that the optionality afforded to dealers by the *Last Look* feature is being abused, with dealers cherry-picking which orders to execute in order to profit at their customers' expense.

The New York Department of Financial Services (NY DFS) has been active in investigating the practice, issuing subpoenas to several banks, as well as installing monitors at Barclays and Deutsche Bank. Barclays has settled with the NY DFS for $150 million[xix] and with class action plaintiffs for $50 million for issues relating to the *Last Look* mechanism. Barclays allegedly received customer orders and if the requested executions seemed to be unfavorable to Barclays, relative to how the market was moving, the bank chose not fill those orders. Deutsche Bank is the defendant in an ongoing class action.

The referenced cases are Axiom Investment Advisors LLC v. Barclays Bank PLC et al (1:15-cv-09323) and Axiom Investment Advisors LLC v. Deutsche Bank AG (1:15-cv-09945).

Poor Execution

Finally, in their agreements with the DOJ, the guilty-pleading banks (Barclays, Citigroup, JPMorgan, and RBS) have admitted to providing customers with suboptimal executions, particularly when working limit orders on their behalf. A limit order is an order in which the customer instructs the broker-dealer to execute at a given rate *or better*.

According to the plea agreements, banks took advantage of limit orders in order to earn an undisclosed spread on the orders – or if they were unable to earn a spread, only partially filled certain orders that could have been completed at the customer's limit.

Barclays admitted to using hand signals to add markups to price quotes for certain clients, so that even clients on an open telephone line would not be able to detect that the prices included mark-ups.[xx]

RBS, for one, would admit that: "We [RBS] have, without informing clients, worked limit orders at levels (i.e., prices) better than the limit order price so that we would earn a spread or markup in connection with our execution of such orders. This practice could have impacted clients in the following ways: (1) clients' limit orders would be filled at a time later than when the Firm could have obtained currency in the market at the limit orders' prices, and (2) clients' limit orders would not be filled at all, even though the Firm had or could have obtained currency in the market at the limit orders' prices."[xxi]

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[i] https://www.justice.gov/opa/press-release/file/922556/download

[ii] https://www.justice.gov/opa/pr/foreign-currency-exchange-dealer-pleads-guilty-antitrust-conspiracy

[iii] https://www.justice.gov/opa/press-release/file/925391/download

[iv] https://www.accc.gov.au/media-release/federal-court-imposes-multi-million-dollar-penalties-on-anz-and-macquarie-bank-for-attempted-cartel-conduct

[v] *In re Foreign Exchange Benchmark Rates Antitrust Litigation* (1:13-cv-07789), Third Consolidated Amended Complaint (at paragraph 150)

[vi] https://www.justice.gov/usao-sdny/pr/manhattan-us-attorney-and-new-york-state-attorney-general-announce-714-million-proposed

[vii] http://www.reuters.com/article/us-state-str-settlement-idUSKCN10706B

[viii] https://www.justice.gov/opa/file/877426/download

[ix] https://www.justice.gov/atr/file/838541/download

[x] https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/8news/20141112-ubs-fx-bericht.pdf?la=en

[xi] http://download.asic.gov.au/media/4121483/029744349.pdf

[xii] http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-455mr-asic-accepts-enforceable-undertaking-from-nab-and-cba-to-address-inadequacies-within-their-wholesale-spot-fx-businesses/

[xiii] http://www.reuters.com/article/court-forex-citigroup-idUSL5N11F3L720150910

[xiv] https://www.bloomberg.com/news/articles/2015-11-17/fired-citigroup-currency-trader-wins-lawsuit-over-rigging-probe

[xv] http://download.asic.gov.au/media/4120995/029744347.pdf

[xvi] *In re Foreign Exchange Benchmark Rates Antitrust Litigation* (1:13-cv-07789)

[xvii] http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf

[xviii] http://www.euromoney.com/Article/3411750/ChannelPage/8959/AssetCategory/16/Barrier-running-investigation-alarms-FX-traders.html

[xix] http://www.dfs.ny.gov/about/press/pr1511181.htm

[xx] https://www.justice.gov/file/440481/download

[xxi] https://www.justice.gov/file/440496/download