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Market manipulation claims: "That's how to do a fix!"

Jonathan Kitchin, Michelmore's, Associate, London, 19 October 2015

Banks have already 'paid the price' for market manipulation in so far as they have paid billions of fines to regulators in Pounds Sterling and US dollars. However, none of those fines has made its way back to customers. Jonathan Kitchin, our resident expert on the crossover between court action and compliance, sifts through the latest tales of skulduggery.

Fines paid to the Financial Conduct Authority (FCA) in the United Kingdom are used to cover investigation costs and then go back to the taxpayer. As a result of the high cost of these fines, we are now seeing a wave of civil claims being made against banks for the recovery of losses that those banks caused, it is claimed, when they manipulated markets.

Civil claims in the English High Court

A number of civil claims have already been issued in the High Court in London relating to Libor (the London Interbank Offered Rate) manipulation. The most common examples of wrongdoing relating to Libor that regulators have identified included false submissions made in order to benefit the bank's own trading position or to improve perception of the bank's creditworthiness and inter-trader bribes; and collusion to influence other panel bank submissions.

As a result, parties to interest-rate-hedge or swap agreements which use Libor as their reference rate are arguing (usually in defence to enforcement action by the Bank of England) that this-or-that bank made an implied representation that it would act honestly and would not manipulate the benchmark that it was using to calculate the customer's liabilities. This is a very significant allegation because one legal remedy to this might be to 'rescind' (effectively, to cancel) the hedge or swap and to claim compensation on the basis that it never existed. This would extend to a refund of payments to date, interest and the cancellation of 'breakage costs.' [These are the difference between the value of the remaining loan repayments at the original fixed rate and their value at the present market rate.] The wider effect that cases like these might have on a financial system containing trillions of Pounds Sterling or US dollars' worth of financial instruments and derivatives linked to Libor cannot be over-estimated. The case of Deutsche Bank AG v Unitech Global Ltd is due to proceed to trial at the High Court in London to decide the point in either 2015 or 2016.

Foreign confidential agreements not a protection for information in England

It has also already been decided that claimants [plaintiffs] are able to obtain a certain level of information that banks might otherwise consider to be confidential. In February 2015, in the case of Property Alliance Group Ltd v The Royal Bank of Scotland plc, the High Court decided that RBS had to disclose documents relating to negotiations with regulators about the manipulation of Libor, even if that meant putting the bank at risk of being in criminal contempt of a 'deferred prosecution agreement' negotiated with the US Department of Justice (DoJ). This case reinforces the point that in English courts, confidentiality and the risk of prosecution in foreign jurisdictions are not defences against disclosure of

documents which are relevant to civil claims. Documents relating to regulatory enforcement action or criminal prosecution are therefore available for claimants to obtain and deploy in civil claims. This 'Pandora's Box' of evidence is only going to grow in the light of the continuing Serious Fraud Office investigation into the manipulation of Libor, Isdafix and FX, due to continue through 2015, and the imminent findings of the European Union's Competition Commission's investigation of alleged Eurobor (Euro Interbank Offered Rate) and Japanese Yen Libor cartels.

EU civil claims related to competition law

Although competition law is enshrined in EU treaties, European jurisdictions are not as advanced as the United States when it comes to making civil claims that are linked to it. Nevertheless, the European Commission's investigation into whether any EU competition laws have been broken regarding market manipulation is very important. A breach of competition law provides an additional legal 'cause of action' or route to claim compensation if more traditional routes based on breach of contract, misrepresentation or conspiracy are unsuccessful.

A further, more significant type of civil claim has recently emerged from the US. Nine banks have agreed to pay $2 billion in settlement to US investors, including hedge funds and pension funds, in relation to the manipulation of foreign currency and exchange rates. This stemmed from legal proceedings in New York in which it was alleged that trades were conducted in an anti-competitive manner (and to the financial detriment of customers) because bank traders collectively abused their dominant position in the market. The US class action alleged that banks conspired to fix the prices of currencies in foreign exchange or foreign currency markets – a collection of markets worth $5.3 trillion per day – in which the defendant banks held a combined market share of more than 90%. To understand how this was possible, US lawyers 'lifted the bonnet' to reveal the inner workings of the foreign currency and exchange market.

Spot price manipulation

Traders have been found to have communicated with each other to co-ordinate the fixture of spot prices – the purchase of one currency for the immediate sale of another (a currency pair). In a spot transaction, the bank quotes a 'bid' price at which it buys and an 'ask' price at which it sells, creating a 'spread.' A bank wants to buy low and sell high with a wide spread, whereas a customer wants a narrower spread that reflects lower prices. Therefore, the act of artificially widening the spread causes customers to pay more and receive less. This affected dozens of currency pairs.

Spot transactions are also the foundation for the pricing of all FX-related [foreign-exchange-related] financial instruments that are sold to customers: forwards, being an agreement to buy or sell at a specified price in the future (or futures where an exchange is used); swaps, which exchange cash flow from one financial instrument for another; and options (and options on futures), being the right – but not the obligation – to buy or sell an asset at a specified price before a specified date. All of these prices are derived from underlying spot prices so that every time spot prices move, the prices of forwards and swap prices move. Since traders are able to analyse their customers' trading histories and predict patterns before an order is placed, the importance of spot transactions and the widespread use of spot prices in financial instruments explains how misconduct in this area has had such far-reaching consequences.

The manipulation of benchmark rates

In addition, traders have been found to have manipulated key FX benchmark rates. A benchmark rate is the median rate of trades during a particular time-period and is used to set a daily rate for spot transactions. The most widely used benchmarks are the WM and Reuters Closing Spot Rates for major currencies traded against the US dollar and the euro which are calculated during the 30 seconds before and after 4pm in London. If a trader can buy the currency that he/it needs to sell to a customer at an average price that is less than the daily fix, he/it will profit from the order. Conversely, if the trader purchases at an average price greater than the fix, he/it loses money.

With this in mind, traders exchanged confidential customer information in chat rooms about pending trades and the point at which customer stop loss and limit orders (a customer uses one of these to sell when a price reaches a certain point to limit losses) would be triggered off. They were able to manipulate the daily fix by flooding the market with large volumes of trades. Such tactics were known as "front-running", "banging the close", "painting the screen" or "taking out the filth", and traders could use them to generate profits, safe in the knowledge of the price at which the currency had already been secured.

These benchmarks are used for the valuation and management of investment portfolios and as 'reference rates' for many a derivative (a financial instrument whose value is dependent on an underlying currency pair). This is useful for pension funds, insurance companies and hedge funds that are not speculating on currency movements but repatriating payments and continually re-balancing their portfolios to take account of domestic and foreign investments. If benchmarks are manipulated, customers therefore do not have access to the best prices.

Some infamous chat room quotes include: "if you ain't cheating, you ain't trying", "that's how to do a fix" and "won't find that in any textbook". Cheating participants ensure secrecy by making chat rooms invitation-only and using code names or mis-spelt words. This can take place worldwide 24 hours a day, with the New Zealand market opening at 7am and trading ending in New York at 5pm, by which time it is

7am in New Zealand again.

The spread of US cases to London and farther afield

The early US settlements very much reflect a pro-claimant litigation culture where claimants can use very wide powers of discovery, the threat of punitive damages decided by a jury and a well-established contingency fee regime to put pressure on financial institutions. The financial, commercial and reputational incentives to settle the class actions must have outweighed the risks of proceeding to trial. However, trends in the US do tend to find their way to Europe eventually.

Lawyers are now investigating similar foreign-exchange-based or currency-based claims for British investors (and investors from financial centres all over the world). This is inevitable and lawyers are bound to use the facts and analysis already undertaken in the US to give themselves a leg-up. In the main, claimants are high-net-worth individuals, large corporations, institutional investors such as hedge funds or pension funds, and local authorities that went into derivatives to manage their exposures to the volatility of foreign exchange. London is a natural starting point, being the largest FX market in the world where English legal concepts relating to implied terms or representations, conspiracy and breach of fiduciary duty are sufficient to mount claims.

The double-edged sword of truth

Any US class-action style litigation involving banks in London and Europe will take its toll (which executives and shareholders of banks will be keen to minimise) on profits and therefore share prices. If any bank starts to defend a claim on the grounds that it is not responsible for the acts of employees acting fraudulently (or criminally), claimants and courts will investigate the ways in which the bank monitored its relationship with customers and whether it should have identified, or was aware but turned a blind eye to, the fact that misconduct was taking place. This would call for a probe into whether its policies were consistent with its legal duties, regulatory obligations and other banking standards, and whether it was following them. If damning evidence is available, especially from regulatory investigations or criminal prosecutions, this defence is a double-edged sword for banks.

A final issue to consider is the fact that disgruntled city traders who were dismissed by banks in the wake of regulatory intervention have lodged claims in employment tribunals. These former traders are accusing banks of making them redundant because they were 'blowing the whistle' with the altruistic aim of raising concerns or challenging trading practices. Some traders have also made the embarrassing allegation that their managers and senior executives knew about their practices, encouraged them to participate in chat rooms and then decided to dismiss them as a damage limitation exercise. Traders who can convince the courts that they are 'whistle-blowers' can claim an unlimited amount of damages, whereas employment tribunal compensation is otherwise capped at approximately £80,000. Given that traders are high-net-worth individuals who have been earning large sums of money (including bonuses), these are large claims – and there is a strong financial and reputational incentive for the traders to pursue them as they are now likely to find it very hard to find the same kind of employment elsewhere. At least half a dozen traders have made such claims, some of which should reach a conclusion before the end of 2015, unless they are settled behind the scenes.

The banking and financial services industry will come under further scrutiny as we go into 2016 with no respite. Some believe that these cases are likely to damage the British economy and question whether some of the largest international banks will remain domiciled in London. However, although the banking industry is a bedrock of the UK's economy, part of the reason why businesses from all over the world set up in the UK is the quality and impartiality of its legal system. It provides a reliable foundation from which businesses and customers can invest. If there has been wrongdoing, the legal process should follow its natural course and customers who have suffered should receive redress. As a general rule, the recovery of legal costs in the UK tends to follow the outcome of a case, so banks should not suffer financially if there is no case to answer.

It will be difficult to track the volume of claims being made, other than by reference to the banks' accounting records. We can, however, expect banks to make further provision for litigation costs and settlements – HSBC has just added £350 million to its provision to resolve forex-related claims. This is just one of several regulatory issues that I shall be keeping a close eye on in the coming months.

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