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FINANCIAL SERVICES REGULATORY UPDATE:

FX INVESTIGATIONS: LESSONS LEARNT FROM INTERNATIONAL INVESTIGATIONS

As the Australian Securities and Investments Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC) continue their respective investigations of the conduct of financial institutions in relation to foreign exchange (FX) currency markets and the Bank Bill Swap Rate (BBSW), lessons can be learnt from the investigations and prosecutions of financial institutions for similar conduct in the United Kingdom (UK) and the United States (US). The lessons are drawn from DLA Piper's representation of clients in the UK and US proceedings and continued representation of clients in other similar investigations.

BACKGROUND

Following speculation of troubling trading patterns in the London Fix from as early as 2006, regulators launched investigations in 2013 into the foreign exchange (FX) currency market. In November 2014, the Financial Conduct Authority (FCA) - the financial regulatory body in the UK in conjunction with Swiss regulator (FINMA) and the US Regulator - the Commodity Futures Trading Commission (CFTC) announced bank fines of more than US $4 billion for the "attempted manipulation of, and for aiding and abetting other banks' attempts to manipulate global foreign exchange benchmark rates to benefit the positions of certain traders." In July 2014, the Director of the Serious Fraud Office, an independent UK Government department that investigates and prosecutes serious or complex fraud and corruption, confirmed that it had opened a criminal investigation into allegations of fraudulent conduct in the FX market.

INITIAL RUMOURS INTO THE FX MARKET

The spot FX market is a wholesale financial market and spot FX benchmarks (also known as "fixes") are used to establish the relative value of two currencies. Fixes are used by a wide range of financial and non-financial companies, for example to help value assets or manage currency risk. Traders at these banks establish benchmark exchange rates to enable many market players to settle their foreign currency transactions.

The FCA's initial investigation sought to focus on the G10 currencies, which are the most widely-used, and on the 1600 hours WM Reuters (WMR) and 1315 hours European Central Bank (ECB) fixes, for continued manipulation of exchange rates in the foreign exchange market. Of particular concern was the rigging of the FX market in two ways; (1) by colluding to manipulate the daily "fix"; and (2) by intentionally triggering their client's stop-loss orders in order to manipulate the price.

FX prices are set entirely by observable transactions rather than a benchmark created by quotes from a handful of traders (like LIBOR). Manipulating the fix could involve traders sharing information on their positions or agreeing in advance how they would trade the market during the set windows when rates were set. Additional information on bank positions or an agreement on trades would increase the ability of the bank to ensure that when the fix was established its overall book was in profit.

It also appeared that traders passed on information to other individuals at different companies about big upcoming trades through participation in conversations in computer chat rooms, usually via Bloomberg or Reuters terminals. At times, in certain chat rooms, FX traders disclosed confidential customer order information and trading positions, altered trading positions to accommodate the interests of the collective group, and agreed on trading strategies as part of an effort by the group to attempt to manipulate certain FX benchmark rates.

Further investigations continue into sales practices in the FX markets.

KEY FAILURES

Failures in connection with the FX scandal are twofold: those in relation to the banks and those in relation to individual traders.

BANK FAILURES

The FCA investigation involved the "Relevant Period" of 01 January 2008 to 15 October 2013. Some of the failures were that banks failed to take reasonable care to organise and control their affairs responsibly and effectively deal with adequate risk management systems in relation to G10 spot FX voice trading in London. Banks relied primarily upon their front office FX business to identify, assess and manage risks arising in that business.

In addition the front offices failed adequately to discharge these responsibilities with regard to obvious risks associated with confidentiality, conflicts of interest and trading conduct.

Failings in this regard allowed the following behaviours to occur:

1 Attempts to manipulate the WMR and the ECB fix rates, alone or in collusion with traders at other firms, for the banks own benefit and to the potential detriment of certain of its clients and/or other market participants;

2 Attempts to trigger clients' stop loss orders for the banks own benefit and to the potential detriment of those clients and/or other market participants; and

3 Inappropriate sharing of confidential information with traders at other firms, including specific client identities and, as part of 1 and 2 above, information about clients' orders.

ALLEGATIONS AGAINST TRADERS

In addition to this, the investigations have led to regulators uncovering collusion by bank traders designed to control the flow and pricing of trading during the relevant time periods, so as to manipulate WMR rates to their advantage, but at their clients' direct expense. The allegations are broadly that traders were front running client orders, engaging in trading practices designed to affect the rate and colluding with traders at other banks to increase the prospects of doing so successfully. The evidence acquired by the regulators includes transcripts from Reuters instant message chat rooms participated in by some of the most senior FX traders in the market. The regulatory findings range from a lack of proper supervision that would have prevented the misconduct, to attempted manipulation, although investigations continue to prove whether this behaviour was a result of individual wrongdoing and illegal activity.

Since the investigations began, over 30 bankers have been sacked or suspended. On 19 December 2014 the UK made the first UK arrest over the FX scandal for suspicion of rigging. It has yet to be seen whether any criminal prosecutions will follow.

PRACTICAL LESSONS LEARNT:

Failure to apply previous lessons from regulatory action

The firms involved (Citigroup, HSBC, JP Morgan, RBS and UBS) are paying 20 percent more than the same authorities have levied from the five firms for the LIBOR scandal. This reflects the banks' failure to learn their lesson. Misdeeds in FX went on as recently as October 2013. This is more than two and a half years after the first reports of a regulatory investigation into LIBOR manipulation and well over a year after Barclays became the first bank to settle over LIBOR. The size of the fines reflects both the gravity of the misconduct but also a need to punish more harshly than before, because of the failure of the banks to learn and apply the lessons from the previous investigations.

SPECIFIC ACTIONS REQUIRED

For banks, there are many practical lessons to be learnt. As stated by Martin Wheatley chief executive of the FCA, firms must ensure that their traders do not game the system to boost profits or leave the ethics of their conduct to compliance to worry about. With such a focus on the integrity of the FX market and the banking sector, there is a "wake-up call on self-policing."

Specific actions include:

1 Re-validation of the Bank's Governance and its Three Lines of Defence to ensure:

- a) The effectiveness of its frontline risk management controls;
- b) Comprehensive oversight over the operation of the internal control framework by the specialist control functions (risk and compliance);
- c) Independent assurance provided by an independent audit function.

2 A cultural change, on the trading floor and generally, led by senior management to ensure that the highest standards of integrity operate across all trading businesses;

3 Enhancing policies, procedures and guidance related to: confidentiality, conflicts of interest, trading conduct, market colour, client orders and fix orders;

4 Annual training for all FX employees concerning appropriate trading behaviour;

5 Restricted participation by traders in multi-bank chat rooms;

6 Strengthening surveillance of trading desks;

7 Close monitoring of communications with clients and employees of other banks: the technology now exists for self-learning monitoring systems that can detect potentially anti-social trader behaviour. This includes looking for known patterns of abusive behaviour, as well as patterns of behaviour that deviate by a significant degree from "the norm." Both types of pattern (or a combination) may indicate something for the compliance department to look into.

8 Clear guidelines for leavers and joiners regarding the use of confidential information and interaction with former colleagues;

9 Greater training and awareness of prohibited anti-competitive practices;

10 Improving customer disclosures relating to FX fix orders.

HOW CAN WE ASSIST?

DLA Piper can assist you with:

- Independent investigations, audits and reviews;
- Second opinions on potential liability and strategy;
- Strategic advice with respect to the Corporations Act and the Competition and Consumer Act liability and defence;
- Representation of individual traders and employees of financial institutions;
- Engagement with regulators and assistance with dawn raids and evidence requests;
- Reviews of the bank's compliance policies and procedures;
- Training for senior management and individual traders/employees; and
- Employment disciplinary processes and claims.

MORE INFORMATION

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