

## The Johnson Conviction And Fallout For Forex Market

By Paul Hinton, Andrew Newman and George Oldfield

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Mark Johnson's recent conviction for wire fraud highlights the use of criminal prosecution to police trading practices in institutional financial markets. Federal prosecutors secured a conviction of HSBC's former foreign exchange executive by arguing successfully that HSBC had an inferred fiduciary duty to its customer and that Johnson violated it by misappropriating inside information in a large FX trade. At issue was the practice of pre-hedging, or assembling a position to execute later against a very large block order of FX. Pre-hedging or positioning in advance of an anticipated block order has long been a common method of managing liquidity in lightly regulated FX markets.



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One potential consequence of Johnson's conviction could be a reduction in liquidity for block trades in the FX and other over-the-counter (OTC) markets. Another possible consequence could be the adoption of more explicit contract terms for block trade positioning, pricing, risk bearing and compensation. More block FX trades could move to dark pool types of markets to insulate large orders from perceived front running as has happened in equity and other derivative markets. These responses would substitute new sorts of formal contracts, trading mechanisms and costs for traditional, less formal OTC trading arrangements in FX markets.



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### Background

Cairn contracted with HSBC in December 2011 to execute a \$3.5 billion FX transaction to convert the proceeds of a corporate transaction into pound sterling.[1] Cairn's agreement with HSBC was the outcome of a request for proposal (RFP) by Cairn for dealers to provide proposed mechanisms for executing the sale of \$3.5 billion in exchange for pounds.[2] While Cairn used the RFP process to choose a bank and its proposed trading strategy, it did not impose detailed requirements on the bank's conduct of its strategy. Such requirements are critical dimensions of best execution as it is defined in other markets.[3] HSBC responded to the RFP with a number of alternative techniques for Cairn to consider, including HSBC's provision of liquidity through pre-hedging or buying the pounds before the London fix as principal and then selling them to Cairn at the fix price.[4] HSBC also agreed to use the information in



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the RFP solely to analyze its proposed FX transaction[5] and stated "... we would like to execute the trade in the best interest of the company." [6] Cairn chose HSBC's proposed strategy to deliver pounds at the 3 p.m. London fix price with no explicit restrictions on HSBC's pre-hedging strategy or any explicit written requirement for HSBC to execute its strategy for the sole interest of Cairn.

HSBC's technique for executing the trade was to pre-hedge as principal leading up to the London fix on the trade day. At HSBC, Johnson was recorded during the pre-fix trading saying, "make sure we don't ramp it up through there," referring to the potential impact of its pre-hedge buying on the eventual price at fix. [7] It appears that HSBC was buying pounds in quantity right up to the fix rather than assembling its pre-hedge position quietly ahead of time. Regardless, HSBC allegedly made \$7 million by delivering its pre-fix position to Cairn at the fix price. [8] This amounted to 23 basis points on the trade in addition to the fee. While a plain-vanilla trade of \$10 million for pound sterling would typically execute with no fee and a one pip spread (0.75 basis points at the current exchange rate), a large block would normally be more costly to execute and would command a significant pound markup. The issue here was the size of the markup and how it was captured by HSBC.

The prosecution argued that HSBC's agreement with Cairn put it in a fiduciary-like relationship and so it should have acted solely in Cairn's interest to deliver pounds at the fix price or better. According to the government, HSBC effectively misappropriated the order information to benefit itself by pre-hedging or front running at better prices than the price for pounds it delivered to Cairn.

### **Liquidity and Market Structure**

Differences in financial market structures make one-size-fits-all policing of trade execution problematic. What might be construed as front running in the retail equity exchange market might be characterized as positioning for a block trade in the block market. Best execution of a trade depends on the trade's size and the customer's demand for immediacy and risk avoidance.

Exchange markets provide liquidity and immediacy for round lot market orders. In interconnected retail markets for equities, futures and options, central limit order books, simple trade types and rules, and relatively small round lots provide pre-trade transparency for market participants. Brokers provide retail customers with trading services for fees and market makers' spreads are invisible to customers. Large blocks are seldom traded on an exchange as a block. Rather, the transaction is either negotiated with a dealer directly for an OTC trade, dribbled out to an exchange in small lots, or moved to a dark pool for execution against other blocks if possible.

OTC markets, where institutions normally trade, generally have deeper liquidity provided by competing dealers but provide less trade transparency. Institutions execute market orders directly with dealers by first calling a few market makers and getting indicative quotes, then executing through a chosen dealer. Even in OTC markets, however, a large block trade requires special treatment. A request for an immediate block trade usually requires a significant price concession relative to a round lot, a large fee, or a make-whole or risk-sharing agreement. [9] As an alternative to immediate execution, a large order can be worked by a dealer with the trade broken into pieces and traded over an agreed amount of time. Such arrangements are routinely negotiated quickly over the phone. A bank may also provide a customer with a trading algorithm that allows it to perform this breakdown task itself. This shifts the trading risk wholly to the customer. In summary, execution quality has several dimensions and cannot be separated from the mechanism chosen to execute the trade and the trade agreement between the customer and dealer.

## **What Made the Cairn Deal Different**

The treatment of FX pre-hedging or positioning in anticipation of a trade as front running, which is prohibited in securities markets, is not entirely novel. But the criminal conviction of a trading executive for pre-hedging has shocked market participants. The technique that HSBC used to pre-hedge the customer's order was similar to standard industry practice. It was recommended in HSBC's response to the RFP and agreed to by Cairn. In such a case, a dealer provides liquidity and immediacy to the customer while the dealer bears risk in its position leading up to the uncertain fix price. For handling a special trade execution a bank normally earns a commission or fee (but not in this case). For assuming risk by positioning ahead of a trade, the bank attempts to make a spread.

The prosecution alleged that the differences between HSBC's handling of the Cairn transaction and common practices were three elements of the trade. The first element was the large spread gained by HSBC on the trade. The second was the lack of contract clarity that allowed the inference that HSBC was participating as a fiduciary in the trade rather than a traditional principal counterparty. Having responded to the RFP seeking best execution, signed the confidentiality agreement and made representations, the prosecution argued successfully that Johnson was assuming a fiduciary-like role (involving a "duty of trust and confidence") rather than acting as a self-interested dealer. The third element was the apparent price ramp up to the fix caused, the prosecution argued, by HSBC's own pre-hedge buying. This was construed as self-dealing market manipulation, which eliminated the trade's risk. Alternatively, the price response to the pre-hedging might have reflected the limited liquidity in the market in which case HSBC assumed some risk when it bought its pre-hedge position because it could not be certain that the fix price would remain elevated rather than reverting immediately to the pre-hedge price level due to other trading activity.[10]

## **Going Forward**

At present, there is no legal definition of excess markups or front running in FX markets. Major FX market participants are attempting to provide greater guidance on the topic of execution quality through the FX Global Code. In terms of trade execution, the code recommends that FX participants disclose to customers the capacity (principal or agent) in which they act prior to trade execution. Different instructions are agreed upon between the customer and bank based upon the capacity in which the bank is operating. While the FX Global Code is helpful in terms of defining responsibilities in FX trading, the document is merely "... a set of global principles of good practice." The Global Code "... does not impose legal or regulatory obligations on market participants, nor does it substitute for regulation, but rather it is intended to serve as a supplement to any and all local laws, rules, and regulations." [11]

Meanwhile, the positioning technique of pre-hedging, or the practice of trading in advance of the fix, is widely employed by dealers to balance their order books and set up for any anticipated large block trades by customers. Customers generally understand this activity as routine and necessary in the FX marketplace. In fact, it is pre-fix trading and information on customer interest or "color" garnered in sales calls in anticipation of orders that give dealers the information they need to quote for trades at the fix itself.

Since the settlements in the recent FX benchmark rate manipulation litigation, dealers and customers now more often choose to enter agreements for trades in which predetermined total fee schedules are set for trade executions. Such contracts have the potential to change the structure of the FX dealer markets in terms of pre-hedging activity and risk bearing. The potential inference of fiduciary duty also

now exists for dealers. Thus, trade records must carefully document execution quality by comparing fees, spreads, positions and times of trades to the terms of a trading agreement. This creates additional costs incurred in front offices, back offices and compliance monitors in FX dealers. The dealers will naturally attempt to pass these costs on to customers.

Driven by increased scrutiny of FX OTC trading, dealers are asking regulators for additional clarity on what constitutes front running. Banks are now requesting explicit permission to pre-hedge orders within the terms and conditions of principal trading agreements negotiated with customers. The Johnson conviction will likely increase such efforts to reduce litigation risk, delineate trading risks and pass on costs. It may also reduce liquidity. The fallout from Johnson's conviction could also spread to other OTC markets in which positioning for large trades has been a routine trading practice.

*Correction: An earlier version of this article incorrectly stated that HSBC earned a fee. The error has been corrected.*

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[1] Cairn also engaged Rothschild & Co. to advise it on the FX transaction.

[2] The RFP had the express purpose of determining "... how to best execute the trade." Cairns wrote that it would select a bank "... on the basis of price, suitability of the recommended strategy to delivery (sic), best rate at the lowest risk to the Company and quality of their responses to the RFP." US v. Johnson, 16 CR 457 (NGG), The Government's Supplemental Memorandum in Support of its Motion in Limine, 9/7/17, Document 108-2, "REQUEST FOR PROPOSAL: CAIRN ENERGY PLC, 4th October 2011, Request for proposal-FX Hedging Execution Bank."

[3] For example, in equities, options and fixed-income markets, FINRA Rule 5310 requires broker-dealers to "... use reasonable due diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." The rule goes on to list a large number of factors the broker-dealer should consider such as the type of security, the variety of trading venues, and the size of the trade for executing at the most favorable price for the customer.

[4] Note that the prosecution argued that by specifying the 3:00 fix, which is less liquid than the 4:00 fix, HSBC gave itself an easier event to manipulate.

[5] US v. Johnson, 16 CR 457 (NGG), The Government's Supplemental Memorandum in Support of its Motion in Limine, 9/7/17, Document 108-1, Confidentiality Agreement.

[6] US v. Johnson, 16 CR 457 (NGG), The Government's Supplemental Memorandum in Support of its Motion in Limine, 9/7/17, Document 108-3, "Project Shine Request For Proposal- FX Hedging October 2011," p.5.

[7] "HSBC forex trial, Commerzbank and Alphasense," FT Banking Weekly podcast, Oct. 24, 2017.

[8] According to the government, "[t]he scheme netted over \$600,000 in Mr. Johnson's trading books and over \$6 million in profit for the bank." Government Summation, Trial Transcript, p. 2389, lines 20-22.

[9] Because dealer-to-dealer FX trades are name give up, a bank's attempt to execute a block immediately through indicative bid requests alerts other dealers that a block trade is pending and gives them an opportunity to trade against the block.

[10] According to the Bank for International Settlements, the daily volume of spot pound-dollar FX transactions was at least \$139.6 billion in 2010. See Bank of International Settlements, Triennial Central Bank Survey of Foreign Exchange and Derivative Market Activity in 2010-Final Results, p. 54.

[11] See [https://www.globalfx.org/docs/fx\\_global.pdf](https://www.globalfx.org/docs/fx_global.pdf).