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Global Financial Regulators Issue Record-Breaking Fines for Foreign Exchange Benchmark Rate Manipulation

On November 12, 2014, the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), the UK's Financial Conduct Authority (FCA), and Switzerland's Financial Market Supervisory Authority (Finma) collectively issued US$4.3 billion in fines and penalties against six financial services firms for "attempted manipulation of, and for aiding and abetting other banks' attempts to manipulate global foreign exchange (FX) benchmark rates to benefit the positions of certain traders."[1] These newest fines bring total penalties for benchmark manipulation to more than US$10 billion over a two-year period. Additionally, regulators are requiring these firms to undertake remedial measures to prevent similar incidents from occurring in the future.

FX benchmark rates are used to establish the relative values of different currencies, which reflect the rates at which one currency is exchanged for another, and are used for pricing of FX swaps, cross-currency swaps, spot transactions, forwards, options, futures, and other similar derivative instruments. Manipulation of the nearly US$5.3 trillion a day FX market – which has remained largely unregulated – has the potential to have a wide-reaching effect on members of the public around the globe. As such, the integrity of FX benchmark rates is critical to ensure continued confidence in US and international markets.

This publication provides an overview of the firms' alleged conduct with regard to FX benchmark rates, discusses the legal significance and repercussions of such action, and provides a brief overview on continuing developments in the FX marketplace.

Background

After conducting a more than year-long investigation, regulators found that numerous FX traders had been engaging in efforts to manipulate the World Markets/Reuters Closing Spot Rates (WM/R Rates), which are the most widely referenced FX benchmark rates in the US and around the globe. According to regulators, certain FX traders at various firms coordinated their trading with traders at other firms in an attempt to manipulate the "WM/R 4 p.m. London fix," which is calculated at 4 p.m. London time. For 21 of the most liquid currencies, the WM/R 4 p.m. London fix is based on actual trades, using bids and offers extracted from an electronic trading system during the fix period. For the other 139 less liquid currencies, the WM/R 4 p.m. London fix relies on indicative quotes derived from a Reuters feed that solicits "indications of interest" from market participants. Regulators claim that traders used private chat rooms to disclose confidential customer order information and trading positions, alter trading positions to accommodate the interests of the collective group, and agree on trading strategies.

Separately, regulators found that certain firms failed to adequately assess the risks associated with their FX traders participating in the fixing of certain FX benchmark rates and lacked adequate internal controls for and oversight of their FX traders to prevent this improper behavior. Regulators also determined that the firms lacked sufficient policies, procedures, and training specifically governing participation in trading with regard to FX benchmarks rates. Notably, some of this conduct occurred during the same period that firms were already on notice that regulators were investigating attempts by certain firms to manipulate the London Interbank Offered Rate (Libor) and other interest rate benchmarks.

Legal Significance and Repercussions of Alleged Misconduct

As discussed above, the alleged misconduct of six financial services firms has resulted in a combined US$4.3 billion in fines and penalties by four regulators from across the globe, which demonstrates the improving cross-border collaboration between regulators. Regulators also imposed requirements that these firms take steps to strengthen their internal controls and procedures relating to their participation in the fixing of FX benchmark rates and supervision of their FX traders.

CFTC

The CFTC entered into settlement agreements with five financial services firms for conduct occurring between 2009 and 2012. In the settlement agreement, the CFTC alleged that the firms violated the Commodity Exchange Act (Act) and Commission regulations by: (1) attempting to manipulate the price of a commodity in interstate commerce;[2] (2) aiding and abetting the attempts of traders at other firms to manipulate FX benchmark rates[3]; and (3) being strictly liable for the acts of their traders engaging in price manipulation.[4]

1 CFTC Press Release (Nov. 12, 2014), *available at:* http://www.cftc.gov/PressRoom/PressReleases/pr7056-14.

2 Sections 6(c), 6(d) and 9(a)(2) of the Act (7 U.S.C. §§ 9, 13b and 13(a)(2) (2012)) prohibit attempted manipulation. With respect to conduct on or after August 15, 2011, in addition to Sections 6(c), 6(d), and 9(a)(2), Section 6(c)(3) of the Act (7 U.S.C. § 9(3) (2012)) prohibits the attempted manipulation of the price of any commodity in interstate commerce. Commission Regulation 180.2 (17 C.F.R. §180.2 (2014)), which became effective on August 15, 2011, in relevant part, makes it "unlawful to … directly or indirectly to attempt to manipulate, the price of …any commodity in interstate commerce." Regulation 180.2 codifies Section 6(c)(3). Note that two elements are required to prove an attempted manipulation: (1) intent to affect the market price, and (2) an overt act in furtherance of that intent.

3 Section 13(a) of the Act (7 U.S.C. §13c(a) (2012)), prohibits aiding and abetting attempted manipulation. Liability as an aider and abettor requires proof that: (1) the Act was violated; (2) the aider and abettor had knowledge of the wrongdoing underlying the violation; and (3) the aider and abettor intentionally assisted the primary wrongdoer.

4 Section 2(a)(1)(B) of the Act (7 U.S.C. § 2(a)(1)(B) (2012)) and Regulation 1.2 (17 C.F.R. § 1.2 (2014)) impose strict liability on principals for the actions of their agents.

Collectively, the CFTC imposed more than US$1.4 billion in civil monetary penalties on the five firms, with fines ranging from US$310 million to US$275 million. Additionally, as part of the settlement agreements, these firms were required to "cease and desist" from further violations and take steps to implement and strengthen their internal controls and procedures to provide better supervision of their FX traders and ensure the integrity of their participation in the fixing of FX benchmark rates, as well as internal and external communications by traders. Specifically, these firms are required to implement internal controls and procedures that:

1. enhance the detection and deterrence of improper communications concerning FX benchmark rates;
2. enhance the detection and deterrence of trading or other conduct potentially intended to manipulate directly or indirectly FX benchmark rates;
3. require periodic audits, at least annually, of the firms' participation in the fixing of any FX benchmark rate;
4. require supervision of trading desks that participate in the fixing of any FX benchmark rate;
5. require routine and on-going training of all traders, supervisors, and others who are involved in the fixing of any FX benchmark rate;
6. implement processes for the periodic but routine review of written and oral communications of any traders, supervisors and others who are involved in the fixing of any FX benchmark rate (the firms are required to document the review and maintain the documentation for a period of three years); and
7. implement systems for reporting, handling, and investigating any suspected misconduct or questionable, unusual or unlawful activity relating to the fixing of any FX benchmark rate with escalation to compliance and legal and with reporting of material matters to the executive management of the firms and the CFTC, as appropriate (the firms are required to maintain the record basis of the handling of each such matter for a period of three years).

Further, the firms are required to report to the CFTC within 120 days of their settlement agreements as to the status of their remediation efforts. Moreover, within one year of the settlement agreement, the firms must submit a report (certified by their executive management) to the CFTC explaining how they have complied with the agreement's requirements. Additionally, the firms are required to fully cooperate with the CFTC in any future action related to the rigging of FX benchmark rates.

Despite the firms' alleged misconduct, the CFTC recognized their cooperation during the investigation, seemingly suggesting that their "significant remedial action to strengthen the internal controls and policies" may have had a favorable impact on the settlement agreement.

OCC

Separately from the CFTC, the OCC assessed US$950 million in fines against three financial services firms for "certain deficiencies and unsafe or unsound practices" related to their FX business where they were acting as principal between 2008 and 2013. Two of the firms were fined US$350 million, while another firm (which was not fined by the CFTC or other international regulators) was fined US$250 million. As with the CFTC, the agreements required all three firms to improve their monitoring of FX traders and address any deficiencies in their internal controls. The agreements highlighted that these issues had previously been raised during the Libor scandal, but also appeared to credit the firms for having already begun to take steps to remedy deficiencies and unsafe or unsound practices.

FCA

In addition to the fines imposed by US regulators, the FCA imposed US$1.7 billion in fines – the largest fines in London's history – on five firms for failing to exercise adequate and effective control over their FX trading businesses, with fines ranging from US$371 million to US$343 million. According to the FCA, the five firms received a 30% discount on their fines for settling early. The FCA also announced that it had cleared several other financial services firms of any wrongdoing; however, the agency is continuing its investigation of one firm that recently pulled out of settlement discussions.

While the FCA recognized that there are no specific rules governing the unregulated FX market, it nevertheless emphasized the importance of managing risks through effective systems and controls. As such, in setting the fine for each firm, the FCA considered, among other things, the firm's relevant revenue, the seriousness of the breach, each firm's disciplinary record and response to the wider issues around the Libor scandal, the degree of cooperation shown by each firm, and the knowledge and/or involvement of certain of those responsible for managing this part of the firm's business.

Finma

In a targeted and separate action, Finma also issued an order resolving proceedings against and requiring disgorgement of US$139 million in profits from one financial services firm for its "serious misconduct." The regulator ordered the firm to cap bonuses for FX traders and use electronic platforms to perform at least 95% of its FX trades. Finma is also continuing to probe 11 of the firm's employees.

What's Next for FX?

The investigation into the rigging of FX benchmark rates has already resulted in major changes, with firms having suspended or fired more than 30 traders, tightened their policies on the use of chat rooms, and increased their use of automated trading. Outside the banking industry, this scandal has reflected poorly on the Bank of England, which has itself already taken action to prevent future misconduct, including firing one of its top officials. It is also anticipated that G20 leaders will soon consider regulatory changes to FX benchmarks. In fact, CFTC Chairman Timothy Massad recently sent a letter to Chairman Mike Conway (R-TX) and Ranking Member David Scott (D-GA) of the House Agriculture Committee with regard to European proposals to regulate commodity benchmarks. Specifically, Chairman Massad noted that he is concerned that the EU's proposal would mean that benchmarks created outside of the EU could not be used by European financial services firms unless the European Commission made the determination that the benchmarks were being adequately supervised, thus having the potential to "have adverse market consequences."

Thus far regulators have announced administrative fines and penalties in the FX probe, but the US Department of Justice (DOJ) and the UK's Serious Fraud Office announced last year that they are also conducting criminal probes of the conduct. In the related criminal probes of the manipulation of the Libor and the Euro Interbank Offer Rate (Euribor) benchmark rates, the DOJ brought criminal charges and entered into deferred prosecution agreements, including against some of the same banks involved in the FX probe, which led to at least US$550 million in criminal fines and penalties. Similarly large criminal fines are likely in the FX probe. Moreover, the widespread misconduct in the FX market has resulted in civil, criminal, and antitrust investigations by numerous other global authorities against more than 15 banks over allegations of collusion and manipulation of FX benchmark rates.

Additionally, the New York State Department of Financial Services, led by Superintendent Benjamin Lawsky, has refused to join in any settlement agreement with one particular firm because the penalties have not been adequately severe. As such, his department will continue its own probe and has appointed a monitor to review this firm's continuing conduct.

Finally, Section 722 of the Dodd-Frank Wall Street Reform and Consumer Protection Act provides the Secretary of the Treasury with the authority to exempt foreign exchange swaps and forwards from the definition of the term "swap." Under that framework, in November 2012, then-Secretary Timothy Geithner issued a final determination exempting those products from the swaps regulatory framework set forth in the Commodity Exchange Act. Going forward, the Treasury Department may choose to solicit public input, based in part on these settlements, on the merits of retaining the exemption.

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