New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 261—NO. 69

THURSDAY, APRIL 11, 2019

White-Collar Crime

Expert Analysis

# Are DOJ's F/X Prosecutions Ahead Of the Law on 'Trading Ahead'?

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Two recent prosecutions in the foreign exchange (F/X) market raise questions about the use of general criminal statutes to regulate a trading practice that Congress, specialized regulators, and market rules have declined to prohibit. The conduct at issue is what bankers call pre-positioning, and what the government pejoratively labels "trading ahead" or "front running." In both cases, the context was a complex, multi-billion dollar F/X trade between a bank and a major corporation that had the benefit of sophisticated advice and was well able to negotiate different trading terms if it was willing to pay for them.

One such prosecution, *United States v. Johnson*, resulted in a conviction following a four-week trial in the fall of 2017 that is currently on appeal before the U.S. Court of Appeals for the Second Circuit. Another, *United States v. Bogucki*, tried before the U.S. District Court for the Northern District of California this past February, resulted in the dismissal of all charges at the close of the government's case.

### 'United States v. Johnson'

In 2011, Mark Johnson, based in London, was the Global Head of the F/X cash trading at investment bank HSBC when Cairn Energy, a multi-billion dollar oil and gas company located in Scotland, hired HSBC to convert $3.5 billion in U.S. dollars to British pounds. The money was generated from Cairn's sale of its interest in a foreign subsidiary and needed to be converted to pounds for purposes of distribution to Cairn's shareholders.

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Because of the significant size of the exchange, Cairn sought requests for proposal from a number of investment banks before choosing HSBC to conduct the transaction by buying Cairns' dollars and selling it pounds. As part of the RFP process, HSBC and Cairn entered into a non-disclosure agreement in which HSBC agreed it would only use information about the transaction for evaluating and assisting with Cairn's trade. Ultimately, the parties entered into a "Mandate Letter" which set forth the terms of HSBC's engagement. That letter provided that the transaction would be governed by an International Swap Dealers Association (ISDA) agreement.

The ISDA agreement contained standard terms and conditions for a variety of financial transactions including foreign exchange. The ISDA agreement also contained language that HSBC was "not acting as a fiduciary for or adviser" to Cairn, but was "acting for its own account." Finally, the ISDA agreement stated that Cairn had made its own decision to enter into the transaction based on its own independent judgment.

Ultimately, HSBC and Cairn agreed that Cairn would receive the set (or fixed) exchange rate on a given date and time, commonly known as "trading at the fix." This methodology, a popular method of F/X trading because of its perceived transparency, saved Cairn from having to pay HSBC a substantial premium to lock in a guaranteed conversion rate. But as common sense dictates, and as anyone with experience in F/X trading knows, no bank is willing to take on the risk and effort to execute such a trade for free. A fix trade

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entails no express premium, but the bank seeks to make money (and reduce risk) by pre-positioning in advance of the trade to buy the currency (here, pounds) at what it hopes is a cheaper rate than it will sell them to its client at the fix. The evidence at trial indicated that Cairn was aware that HSBC would seek to profit from the transaction in this manner.

HSBC earned $7 million (0.2 percent) of the $3.5 billion F/X transaction by trading ahead of the fixed exchange. Customary with industry practice, HSBC's bankers, including Johnson, bought pounds in the open market ahead of the scheduled exchange time. The price of the pound increased in the period leading up to the fix, but Cairn received precisely what it bargained for—the exchange of all of its dollars for pounds at the fix rate.

Even though Cairn raised no complaint, the government initiated an investigation into the transaction and filed charges. An indictment was filed against Johnson charging conspiracy to commit wire fraud and multiple substantive counts of wire fraud. At various times during the prosecution and in its arguments to the jury at trial, the government appeared to take the position that the heart of the legal violation by HSBC and Johnson was making a profit on the fix trade, or perhaps it was based on the size of the profit. But ultimately the government relied on the misappropriation theory by arguing that Johnson used Cairn's confidential information to purchase pounds ahead of the scheduled exchange, which the government called front-running. Essential to the government's misappropriation theory was its contention that a fiduciary relationship existed between HSBC and Cairn based on assurances made by HSBC employees that they would execute the transaction in Cairn's best interest.

The government also asserted the "right to control" theory—asserting that Johnson deprived Cairn of its right to control its own assets by executing the transaction in a manner designed to cause the price of the pound to spike despite assurances to Cairn that it would not. According to the government, these assurances included: (1) promises made by HSBC during the RFP process that it would not use its knowledge of Cairn's position other than to execute Cairn's trade; (2) statements by Johnson that HSBC would "drip feed" its purchase of pounds to avoid spiking the fix price; and (3) broad statements in the RFP that HSBC would execute the trade in the "best interest" of Cairn.

> The Second Circuit's decision in 'United States v. Johnson' may be influenced by a recent decision by U.S. District Judge Charles R. Breyer of the Northern District of California in 'Bogucki'.

Johnson moved for a judgment of acquittal. The U.S. District Court for the Eastern District of New York denied his motion and the jury found Johnson guilty. Johnson was sentenced to 24 months imprisonment, followed by three years' supervised release, and a $300,000 fine.

On appeal, Johnson argues that the misappropriation theory did not apply because no fiduciary relationship existed between HSBC and Cairn and the trading methodology was fully disclosed and consistent with industry standard. Johnson also contends that the right to control theory of fraud fails because Cairn received the full benefit of its bargain with HSBC and was not materially deceived. Finally, Johnson argues that application of the wire fraud statute to his conduct violates Due Process. Even the government's experts conceded that no rule prohibits trading before the fixed exchange such that Johnson would have suspected that his actions could constitute wire fraud.

In its brief in response, the government focuses primarily on the right to control theory, arguing that Johnson and the HSBC traders deprived Cairn of control of its assets by withholding "economically valuable information" that HSBC traders had purchased pounds ahead of the fix, which caused the price paid by Cairn to be ramped up to the benefit of HSBC. With respect to its misappropriation claim, the government argues that the evidence showed that HSBC and Cairn had a relationship of trust and confidence and that Johnson breached his duty by misusing Cairn's confidential information that it would be undertaking the trade. The government also points to trial evidence of claimed to be secretive conduct by Johnson and others at HSBC indicating that they believed their trading in advance of the fix was improper.

In his reply, Johnson stresses that prior to executing the trade, HSBC and Cairn executed a Mandate Agreement that expressly incorporated the ISDA agreement and disclaimed any fiduciary duties.

A worldwide F/X industry association, ACI-The Financial Markets Association, filed an amicus brief in support of reversal of Johnson's conviction. ACI argues that based on "the undisputed evidence before this Court" and "the long history of development and codification of ethical conduct standards and market custom and practice … it is not plausible that [Johnson] believed HSBC's handling of the Cairn fix order to have been prohibited by any law, regulation or standard of conduct"; rather he had every reason to believe the contrary. ACI further argues that if the conviction is affirmed, the effects will be far-reaching for global markets, pointing out that regulators expressly have declined to regulate trading ahead in transactions like the one at issue: "Indeed, four separate federal agencies, including the CFTC, restrict dealers from transacting F/X for their own accounts in priority to *retail* client orders. No similar statute or regulation extends to dealing between banks and *non*retail customers, despite protracted consideration of the issue."

Northwestern University finance professor and F/X market expert Torben G. Andersen also filed an amicus brief urging reversal. Andersen's brief provides a primer on the F/X market and argues that "[b]y branding pre-hedging as improper front-running, the Government threatens to effectively criminalize a routine practice that benefits customers." Anderson explains that the practice of pre-hedging is well understood by customers and has long been known to regulators who "have wisely declined to prohibit it … Regulators—not prosecutors—are best equipped to understand the tradeoffs and to supervise F/X dealers' conduct accordingly."

In June 2018, in a ruling that may offer hints regarding the appellate court's view of Johnson's conviction, the Second Circuit reversed the district court and granted Johnson's application for bail pending appeal. Although the Circuit's order offers no rationale, Johnson's motion asserted that his appeal raises substantial questions regarding both the misappropriation and right to control theory and that he likely would have completed his 24-month sentence before these issues were resolved if bail were not approved. The appeal is scheduled to be argued later in the spring.

### 'United States v. Bogucki'

The Second Circuit's decision may be influenced by a recent decision by U.S. District Judge Charles R. Breyer of the Northern District of California in *Bogucki.* Robert Bogucki, the New York-based head of foreign exchange trading at Barclays, was charged with one count of conspiracy to commit wire fraud and six substantive counts of wire fraud for trading ahead of an F/X transaction by Barclays client Hewlett Packard (HP). Specifically, HP sought to purchase $11 billion in options to buy British pounds for its planned acquisition of a United Kingdom based software company.

Similar to Cairn and HSBC, HP signed the standard ISDA agreement stating that each company was acting as principal and not as agent or fiduciary to the other. The government relied on the same two theories of liability as in *Johnson*—that Bogucki misappropriated HP's confidential information in violation of a duty or deprived HP of its property through material misrepresentations and half-truths.

At the close of the government's case at trial, Judge Breyer granted in its entirety Bogucki's motion for acquittal under Fed. R. Crim. P. 29, finding that no reasonable jury could convict on the facts presented. As to the misappropriation theory, Judge Breyer found no basis to conclude that Bogucki had a duty of trust and confidence to HP. He opined that the mere fact that HP had shared information with Barclays was insufficient to create such a duty. Notably, Judge Breyer distinguished the case before him from the district court's decision denying a Rule 29 motion in *Johnson*, because HSBC had signed a non-disclosure agreement with its client, which Barclays had not.

With respect to the second theory of liability, the government presented evidence of conversations between Bogucki and individuals at HP to the effect that Barclays would not "go near the market" and presentations shown by Barclays to HP which emphasized the significance of confidentiality and a "quiet execution." The government argued that all of these statements could have led HP to infer that Bogucki was promising not to drive down the market. Judge Breyer rejected the government's analysis, finding that particularly where the HP representative was experienced in the F/X market and admitted that he, too, was bluffing and posturing in his statements toward Bogucki, the evidence did not support a conclusion that statements or omissions made by Bogucki were capable of influencing HP's decision to "part with its money or property."

In conclusion, Judge Breyer wrote, "A touchstone of our criminal law is that no person 'shall be held criminally responsible for conduct which he could not reasonably understand to be proscribed.' Here, the Government has pursued a criminal prosecution on the basis of conduct that violated no clear rule or regulation, was not prohibited by the agreements between the parties, and indeed was consistent with the parties' understanding of the arms-length relationship in which they operated."

### Conclusion

Johnson's arguments appear highly persuasive that, as a matter of black letter contract law, the non-disclosure agreement and sales pitch documents proffered by the government fail to create a fiduciary duty and thus fail to distinguish his case from Bogucki's. However labelled, Johnson's trading in advance of his client appears to have been well-recognized, commonplace conduct necessary to the functioning of the market and not barred by any applicable rule.