The FX Remediation Programme

Produced in partnership with Charles Kuhn, Barrister and Rechtsanwalt
and Tom Bushnell, Paralegal of Hickman and Rose

The manipulation of the foreign exchange market (**forex** or **FX**) by a handful of banks was one of the headline grabbing scandals to come out of the most recent financial crisis. Regulators across the world have strongly condemned the practices involved. This Practice Note will summarise the conduct, and explore in more detail a key part of the Financial Conduct Authority's (**FCA**) response to the scandal–its FX Remediation Programme.

The FX market is one of the world's largest and most liquid markets. In its Final Notices, the FCA cites the Bank for International Settlements (**BIS**) Triennial Central Bank Survey 2013, which said that the daily average volume turnover of the global FX market was over US $5tn.

References:

BIS–Triennial Central Bank Survey: Foreign exchange turnover in April 2013: preliminary global results

Allegations of FX manipulation have centred on the 4 pm WM/Reuters benchmark rate (**WMR fix**), and the 1.15 pm European Central Bank (**ECB**) fix. Both are currency fixes set daily, and are calculated on the basis of FX transactions carried out in the interbank market. In the case of the WMR fix, at the time of the misconduct, transactions were measured during a 60-second window (30 seconds either side of 4 pm UK time). The ECB fix uses a snapshot of the market at 1.15 pm.

The misconduct was found to have often have occurred in planned private internet chatrooms where traders were able to share information and discuss strategies.

The FCA identified and categorised three main types of misconduct:

- Manipulating the fix–this means an attempt by traders to use influence over the fix to move it in a particular direction (and take their own trading positions accordingly). Influence over the fix was often created (or increased) using a variety of tactics.
- Triggering client stop-loss orders–stop-loss orders allow a client and a firm to agree that the firm will transact with the client if/when the currency in question trades at a given rate in the market. The FCA found that traders were sharing details about their stop-loss orders with traders at other firms. Both would then trade in a manner designed to change the spot FX rate, and thus trigger the stop-loss order.
- Sharing of confidential information–both of the above practices often involved the sharing of confidential information about client orders and positions. In the case of the fixes, by sharing information, traders could view a larger market share, and better predict which way the market (and fix) was likely to move.

The FCA's response to the FX manipulation

The part of the FCA's response that grabbed the headlines was the large fines it handed out to the banks involved. The first tranche of fines came in November 2014. Citibank N.A. was fined £225,575,000; HSBC Bank Plc £216,363,000; JPMorgan Chase Bank N.A. £222,166,000; RBS Plc £217,000,000 and UBS AG £233,814,000. Barclays was fined £284,432,000 in May 2015. These were the largest fines ever imposed by the FCA (or its predecessor, the Financial Services Authority (**FSA**)), and were imposed in tandem with similarly large fines by foreign regulators such as the Financial Market Supervisory Authority in Switzerland (**FINMA**) and the Commodity Futures Trading Commission in the USA (**CFTC**). These fines were premised on the basis of systems and controls failings or, in other words, a failure to exercise adequate and effective control over the relevant parts of their businesses.

Many of the banks involved are believed to have initiated internal investigations into the individuals involved. The outcomes of these investigations may have been passed to the FCA, and potentially the Serious Fraud Office (**SFO**) for action to be taken against individuals. In November 2014, the media reported that the SFO had made its first arrest in relation to FX misconduct.

References:

The Telegraph: First arrest in SFO forex investigation

Finally, the FCA has created the 'FX Remediation Programme', which is explored in detail below.

The FX Remediation Programme

The FCA describes the programme as:

> *'an industry-wide remediation programme to ensure firms address the root causes of these failings and drive up standards across the market. We will require senior management at firms to take responsibility for delivering the necessary changes and attest that this work has been completed'.*
>
> *References:*
>
> *Press Release: FCA fines five banks £1.1 billion for FX failings and announces industry-wide remediation programme*

The rationale and aim of the programme is, therefore, clear: to attempt to change the environment in which the FX manipulation was allowed to occur.

Who is subject to the programme?

The FCA announced in November 2014 that the programme would extend beyond the six major banks fined for FX manipulation, and is now believed to cover 30 firms operating in G10 FX spot trading. The identity of the firms has not been made public.

Key points

Details of what the remediation programme entails have not been released by the FCA, or any firm involved. However the following points can be made about the programme, and should be considered by any firm affected:

- First, and most importantly, any remediation ordered by the FCA will be tailored to the individual firm. There can be no 'one size fits all' approach, and in practice it will depend on factors such as the size of the firm, its market share, and any remedial work already undertaken.
- Key areas of risk that remediation will target include:
    - attempts to collude on fixes
    - inappropriate use of client and trade information
    - maintaining client confidentiality
    - overcharging clients (or 'hard mark-up')
    - proprietary trades
    - layering/spoofing and wash trades
    - front-running
    - compliance with the FCA Code of Market Conduct (**MAR**) in particular MAR 8, and new EU market abuse rules coming into force
- IT issues are likely to be at the forefront of many firms' remediation. Much of the misconduct was found to have occurred in private internet chatrooms, the use of which has since been cracked down upon. But firms will have to reconsider how best to capture, review and monitor the vast amount of messages exchanged by traders every day.
- In some cases, firms will be required to review not only G10 spot FX, but other FX areas such as FX Emerging Markets and FX Sales.
- The conventional three lines of a defence model continues to be crucial, and should be carefully implemented and resourced. In this set up, not only does the tone from the top remain important, but the key role of middle managers has been highlighted by the regulator: Martin Wheatley, the chief executive of the FCA, recently identified this area as a 'blind spot'.

References:

FCA news–Debating trust and confidence in banking

- The FCA will require periodic reports on a firm's progress. As firms are required to be transparent under Principle 11 of the FCA's Principles for Business, any failure to report significant details relating to the programme's implementation could be a breach of the FCA´s Principles for Business as well as obligations under the programme itself.
- Senior managers (**SIF holders**) will be required to sign off on the remedial work. This fits the FCA's increased emphasis on senior manager accountability.

The remediation programme is one which should not be taken lightly and will require significant resources from both firms and the FCA to implement. Failure to implement it could have serious consequences for both institutions and individuals. If the same institutions are investigated for other related misconduct in the future, any failure to comply with the remediation programme could be a significantly aggravating factor in: (i) decisions on the taking of enforcement action; (ii) prohibitions; and (iii) the size of fines imposed on firms and individuals.

The Future of the FX market

The FCA is treating details of the remediation programme as confidential. This is very unlikely to change, unless and until firms fail to comply. However it is not just firms trading in the FX market that are being forced to change their behaviour:

- The WMR fix was widened on 15 February 2015, to a five minute window, with the aim of making it more difficult to manipulate.
- Parliament has expanded the scope of the criminal offence of 'misleading statements in relation to a benchmark' (FSA 2012, s 19) to cover the WMR fix.

References:

SI 2013/637, art 3

FSA 2012, s 19

- On 3 July 2016, the EU's Market Abuse Regulation will replace the EU's 2003 Market Abuse Directive. It will be supplemented by a new Market Abuse Directive on criminal sanctions for market abuse. Financial institutions trading in the UK will need to check that any products (especially derivatives) that are linked to any products trading within the application of the EU MAR comply with those regulations. The directive on criminal sanctions for insider dealing and market manipulation will introduce mandatory criminal sanctions for market abuse and insider dealing offences across the EU. In the UK, the Bank of England, the Treasury and the FCA recently proposed further new criminal offences for market manipulation, and increasing existing sentencing powers.

References:

Regulation No 596/2014

Directive 2003/6/EC

Directive 2014/57/EU

Bank of England–Fair and Effective Markets Review, final report, June 2015

Finally, one of the many lessons to be learned from the LIBOR and FX scandals has concerned the reach of the regulator itself. Slow reactions and suggestions by the FCA that these areas were viewed as outside the scope of the regulated sector have since met with justified scepticism from commentators. Therefore the challenge for the FCA will now be to show that these sorts of proactive remediation programmes can deliver the wide ranging and effective reforms that the industry requires and the public demands.