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# What To Expect In Forex Fraud Trial Of Ex-HSBC Exec

By **Scott Schirick**

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Currency traders worldwide will be watching Monday as opening statements begin in the unprecedented criminal fraud trial of HSBC's former global head of foreign exchange (forex) spot trading, Mark Johnson. In the first prosecution of its kind, the government seeks to criminalize "front-running" in the spot forex market, conduct which the defense has characterized as "common practice" in the industry, and which has long been prohibited in the securities markets.

Prosecutions or enforcement actions against individual forex traders are rare, perhaps because the U.S. spot forex market is so lightly regulated. Strikingly, what regulations do exist do not in fact prohibit the conduct for which Johnson was indicted. The Johnson prosecution in the Eastern District of New York therefore will test whether the government can turn sharp dealing and deception in the unregulated institutional spot forex market into criminal fraud. While there are some parallels to front-running prosecutions in the securities markets, there are also important differences that highlight the challenges the government faces in this novel prosecution.

## Background

In August 2016, Mark Johnson and a co-conspirator, Stuart Scott,[1] were charged with conspiracy and wire fraud for allegedly defrauding an HSBC corporate client, later identified as British oil and gas concern Cairn Energy PLC, in a multibillion-dollar forex transaction in December 2011.[2] The indictment paints a picture of Johnson and Scott scheming to mislead Cairn about the best way to execute the currency transaction, taking favorable, undisclosed positions for themselves and HSBC ahead of Cairn's trade, and then dissembling to keep Cairn from learning about it.

In October 2011, Cairn was preparing to sell its interest in an Indian subsidiary and contacted several banks, including HSBC, to solicit bids on a request for proposal to convert the $3.5 billion in sale proceeds to pounds Sterling ("GBP"). To obtain the details of Cairn's RFP, HSBC and the other banks first had to sign a confidentiality agreement.[3] The government's case against Johnson turns in large measure on HSBC's confidentiality obligations to Cairn, and on a series of representations HSBC made during the bidding process about how it would execute Cairn's proposed forex transaction.

In the confidentiality agreement, HSBC agreed to use the information Cairn provided in the RFP solely to analyze the proposed forex transaction. Using the information for any other purpose required HSBC to obtain Cairn's prior written consent.[4] HSBC's pitch materials also represented that the bank "would work with [Cairn] to ensure best execution [of Cairn's forex transaction] during the day" and "would like to execute this in the best interest of the company."[5] The government alleges that the confidentiality agreement, the "best execution" representations in HSBC's pitch materials, and Cairn's dependence on HSBC's forex trading expertise created a fiduciary duty-like "duty of trust and confidence" between Cairn and HSBC.[6]

Johnson and Scott, individually and through other HSBC traders, allegedly conspired to "front-run" Cairn's order by purchasing GBP in the days and hours leading up to the execution of the Cairn trade. As explained below, while there is no legal definition of "front-running" in the forex markets, generally it means making a proprietary trade ahead of a potentially market-moving customer trade, in order to profit from the inside information. Johnson and Scott also allegedly "ramped" up the price

of Sterling, to their benefit and to Cairn's detriment, by aggressively trading near the time Cairn's trade was executed. According to the indictment, Johnson and Scott also misled Cairn by recommending that Cairn initiate the trade at the 3 p.m. fix rather than the 4 p.m. fix, because they knew that trading at the earlier time would allow them to more easily manipulate the price of Sterling.[7]

The government paints Johnson and Scott as both gleeful and callous. When an independent forex consultant advising Cairn called because he saw the price of GBP rising as the 3 p.m. fix approached, he was told falsely that it was a result of buying by a "Russian name," when in fact it was HSBC itself.[8] When Scott told Johnson that Cairn decided to proceed with the trade despite the rising price, Johnson purportedly exclaimed "Ohhhh, f----ing Christmas," and then discussed with Scott how high they could "ramp" prices until Cairn would "squeal."[9] Johnson and Scott are alleged to have generated around $3 million in illicit profits based on the trades that are now the subject of the action.[10]

## Regulation of the Spot Forex Market

Forex trading is by far the largest financial market in the world, averaging approximately $5.3 trillion dollars a day in activity.[11] The spot forex market is an over-the-counter market and, as such, depends on financial institutions acting as market makers to buy and sell currencies. In the institutional spot forex market — the one at issue in the Johnson prosecution — financial institutions act in a principal capacity, meaning that they act at arm's length to their counterparties in transactions. Courts have noted that, typically, a forex dealer "does not undertake a fiduciary duty when it acts as a principal in transactions with an institutional counterparty in which no trading discretion is conferred."[12] Sophisticated institutional market participants are presumed capable of protecting their own interests.

Despite its size, the spot forex market is minimally regulated in the United States; the institutional spot forex market is less regulated still.[13] For example, regulators of the spot forex market, including the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Commodities Futures Trading Commission, have adopted guidance concerning — but not outright prohibiting — a bank trading ahead of a customer order in the retail forex market.[14] However, those regulations do not apply to the institutional market. Nor does any other U.S. regulation appear to prohibit, or in any way restrict, the ability of a bank to trade ahead of an institutional customer's upcoming spot forex order. Recognizing this fact, the court in Johnson ruled on the parties' motions in limine that the defense may present evidence to the jury to show that "Johnson's conduct was not prohibited[] and was common business practice in the industry" in order to support Johnson's argument that he acted in good faith.[15]

## Front-Running in the Securities Markets

Front-running in the securities markets, on the other hand, is expressly prohibited. FINRA Rule 5270 (Front-running of Block Transactions) prohibits FINRA members from trading ahead of customer orders in securities or related listed derivatives based on "material, non-public market information concerning an imminent block transaction."[16] Similarly, FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) generally prohibits a member from executing its order or another broker dealer's order in an equity security before executing a customer order at the same price.[17]

Not surprisingly, front-running in the securities markets has therefore been the subject of U.S. Securities and Exchange Commission enforcement actions and criminal prosecutions. Cases typically have been pursued under the misappropriation theory of insider trading,[18] which requires proof that the defendant traded on the basis of material nonpublic information and breached a "duty of trust and confidence" owed to the source of the information. For example, in SEC v. Bergin, the defendant Bergin misappropriated confidential information about upcoming client orders from his employer to front-run hundreds of client trades in various energy securities. Bergin used his wife's brokerage accounts to execute the front-running trades without informing his employer (to whom he owed a duty of loyalty), and falsified certain reports to conceal his conduct. Bergin pled guilty to securities fraud, and reached a partial judgment agreement with the SEC.[19]

The "squawk box" cases provide another example. In U.S. v. Mahaffy, brokers from Merrill Lynch, Lehman Brothers and Smith Barney allowed traders from A.B. Watley, a day-trading firm, to listen via

an open telephone line to the brokerages' in-house "squawk boxes" that broadcast pending client orders to buy or sell large blocks of stock. The Watley traders used the information to front-run the brokerages' customer orders; in return, Watley paid kickbacks to the brokers. The defendants were charged with conspiracy to commit securities fraud on a misappropriation theory.[20] Accordingly, to secure convictions, the government had to prove that the defendants understood the squawked customer order information was confidential. Testimony from government witnesses during trial so convinced the jury, which returned convictions.[21]

## Discussion: Challenges Faced by the Government

There are critical distinctions, however, between front-running in the securities markets and in the forex markets. The most obvious, as noted above, is that while front-running is specifically prohibited in the securities markets, there is no such proscription in the institutional spot forex market. Nor at the time was there any relevant guidance or industry practice that would have suggested HSBC ought not execute Cairn's forex transaction the way that it did.[22] As a result, the government's criminal charging theories are different. Johnson is charged with the misappropriation theory of wire fraud and conspiracy. Securities front-running typically is charged under the misappropriation theory of insider trading. Both theories require the existence of a fiduciary duty or a "duty of trust and confidence" that is fiduciary-like, and a breach of that duty by the defendant. In some cases, this duty is clear, as with an attorney-client or employer-employee relationship. But only in the securities markets has the SEC defined where "similar relationship[s] of trust and confidence" that are the "functional equivalent of a fiduciary relationship" arise.[23] In Rule 10b5-2, the SEC established, as relevant here, that a "duty of trust or confidence" is created for purposes of the misappropriation theory of insider trading, "[w]henever a person agrees to maintain information in confidence."[24] Put differently, signing a simple confidentiality agreement is enough to expose a person to potential criminal liability for securities fraud, should he or she violate the agreement by trading.

These distinctions highlight the challenges the government faces in Johnson. The government will have to prove beyond a reasonable doubt both that a fiduciary-like duty existed between HSBC and Cairn, and that Johnson was aware of it. Expect the defense to attempt to undercut these conclusions on several fronts.

For instance, as to the first issue, the defense may argue on numerous grounds that it is unclear the confidentiality agreement, HSBC's representations about "best execution," and Cairn's reliance on HSBC's expertise merged, resulting in HSBC assuming a "duty of trust and confidence." First, unlike the duty imposed by Rule 10b5-2, the confidentiality agreement in itself cannot suffice to establish a "duty of trust and confidence" in the forex market. In the Second Circuit, "a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information."[25] Second, HSBC and Cairn each came to the transaction as commercial parties at arm's length. Thus, unlike an attorney-client or employee-employer relationship, nothing about Cairn's connection to HSBC inherently involved a "duty of trust and confidence." We know this because most institutional spot forex trades are done on a principal basis by market makers with no such duty assumed. Third, as sophisticated commercial actors, if Cairn wanted HSBC to assume a fiduciary duty to it, and HSBC had agreed to do so, the parties could have contracted for it. The fact that they did not may be relevant to assessing the nature of their relationship. Fourth, as noted above, before even awarding the RFP to HSBC, Cairn hired and was being advised on its proposed transaction by an independent forex consultant. This suggests that Cairn was not entirely dependent on HSBC's expertise, and perhaps that Cairn wanted a forex expert to help it monitor HSBC's execution of the transaction. This, too, may undercut a finding that Cairn reasonably viewed HSBC as its fiduciary.

Further, assuming the government establishes that a "duty of trust and confidence" existed, it still will have to prove beyond a reasonable doubt that Johnson knew he was bound by the confidentiality agreement's "no other use" provision and the pitch materials' "best execution" representation. Pretrial filings suggest that the government does not expect to be able to show that Johnson actually read the confidentiality agreement or the pitch materials.[26] Rather, it plans to establish through circumstantial evidence that, whether he reviewed the documents or not, Johnson knew the gist of them because Cairn's order was treated confidentially even within HSBC. It remains to be seen, however, how the government will meet its burden of proving Johnson knew specifically about the "no other use" and "best execution" provisions. The defense can also be expected to argue that the definition of "best execution" in the forex market is unclear. The government's view appears to be that "best execution" means "best price," although the defense will argue that it means "reasonable

execution under the circumstances."

## Conclusion

If the government's theory in Johnson is correct, the dividing line in the spot forex market between entirely unsanctionable client front-running and criminal fraud is in the nebulous space where an otherwise arm's-length transaction between sophisticated counterparties transforms into a fiduciary relationship. Apart from the rare circumstance in which a fiduciary duty is expressly contracted for, it may not always be clear when such an obligation arises between a forex dealer and its counterparty, and what the forex dealer is or is not permitted to do as a result. Whatever the outcome, the Johnson prosecution is sure to have a lasting impact on the forex market, and perhaps determine whether the government will pursue future criminal charges on the same theory.

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[1] Scott, a U.K. resident, was arrested by British authorities in June 2017, and is fighting extradition to the United States. Only Johnson is currently on trial.

[2] Indictment, United States v. Johnson, No. 1:16-cr-00457-NGG (E.D.N.Y. Aug. 16, 2016), ECF No. 9 ("Indictment").

[3] Id. at ¶¶ 11-17.

[4] Id. at ¶ 14.

[5] Id. at ¶ 17.

[6] Id. at ¶¶ 10, 19; see also The Government's Supplemental Memorandum in Support of its Motion In Limine, passim, United States v. Johnson, No. 1:16-cr-00457-NGG (E.D.N.Y. Sept. 7, 2017), ECF No. 108 ("Government's Supplemental Mem.").

[7] Indictment at ¶¶ 20-27, 29, 33.

[8] Id. at ¶ 32.

[9] Id. at ¶¶ 28-29.

[10] Id. at ¶ 30.

[11] Jerry Markham, Regulating the Moneychangers, 18 U. Pa. J. Bus. L. 789, 789 (2016).

[12] Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 118, 150 (S.D.N.Y. 2000); see also Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1038 (4th Cir. 1997).

[13] This stands in contrast to markets for other types of forex transactions, such as forex futures, options or swaps, which are regulated by other bodies such as the CFTC, SEC or OCC.

[14] 17 C.F.R. §§ 5.1, 5.18; 12 C.F.R. §§ 349.14, 349.25; 12 C.F.R. §§ 240.2, 240.13; 12 C.F.R. §§ 48.2, 48.13.

[15] See Defendant's Memorandum of Law in Opposition to the Government's Motion In Limine to

Limit Expert Testimony at 13, United States v. Johnson, No. 1:16-cr-00457-NGG (E.D.N.Y. Sept. 6, 2017), ECF No. 107.

[16] FINRA Rule 5270.

[17] FINRA Rule 5320.

[18] Front-running cases can be viewed as a species of insider trading under the misappropriation theory where the material non-public information is the fact of a large upcoming securities order, and the defendant has a duty to the source of the information about the order not to disclose it.

[19] S.E.C. v. Bergin, No. 3:13-CV-1940-M, 2015 WL 4275509 (N.D. Tex. July 15, 2015); United States v. Bergin, No. 3:13–CR–408–M (N.D. Tex. filed Oct. 16, 2013), ECF No. 1. Bergin reserved the right to litigate the amount of disgorgement in the SEC enforcement action.

[20] See United States v. Mahaffy, No. 05–CR–613(JG), 2010 WL 2925952 (E.D.N.Y. July 21, 2010); United States v. Mahaffy, 499 F. Supp. 2d 291 (E.D.N.Y. 2007).

[21] On appeal, it came to light that the government violated its Brady obligations by withholding transcripts of depositions from other witnesses who testified that the squawked information was not considered confidential. Accordingly, the Second Circuit vacated the conspiracy convictions based on front-running. United States v. Mahaffy, 693 F.3d 113 (2d Cir. 2012).

[22] In May 2017, an organization of forex groups, central banks and private sector financial firms published a voluntary code of conduct called the "FX Global Code," which sets forth non-binding best practices and guidance in the forex markets. The FX Global Code established a number of recommended practices, called "principles," that touch on front-running. For example, Principle 11 provides that market participants should only "pre-hedge," meaning undertake trades to manage risks associated with upcoming client orders for the benefit of the client, when acting as a principal, and should only do so "fairly and with transparency." See FX Global Code (May 2017), https://www.globalfxc.org/docs/fx_global.pdf.

[23] United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991).

[24] 17 C.F.R. § 240.10b5-2(a).

[25] Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980); see also Chestman, 947 F.2d at 568 (noting that a "'relationship of trust and confidence' must share the essential characteristics of a fiduciary association" and go beyond simply entrusting someone with confidential information).

[26] Government's Supplemental Mem. at 5, 7, 10

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