Finance

Legal Alert

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Recent Swap Manipulation Cases

In recent years, the Commodity Futures Trading Commission (CFTC) filed two actions with facts so shocking the reader is forced to ask, 'can this be how the industry really functions?'

The Complaints

The most recent action was filed in February of 2021 in U.S. District Court in the Southern District of New York (SDNY) against a U.S. dollar swaps trader and managing director of a global investment bank for "engag[ing] in a scheme to deceive and to manipulate the price of U.S. dollar interest rate swap spreads…" [1] The facts of this case are very similar to those of a case filed a little more than a year ago – a bond issuance with a governmental issuer, and the pricing of a related swap through an interdealer broker firm. Both cases illustrate potential flagrant violations of the Commodity Exchange Act ("CEA") and CFTC regulations.

To take a closer look, in December of 2019, the CFTC filed a complaint in the SDNY against the Head of North American Rates for a global investment bank[2] for engaging in "a deceptive scheme to manipulate the prices of U.S. dollar [LIBOR] interest rate basis swaps" in a swap between the bank and a governmental bond issuer. The manipulation took place in June of 2012 when the bank, which was both the joint lead manager of the bond deal and the bank counterparty on the related swap, was pricing the swap for the governmental issuer.

The Objective Pricing Agreement

Prior to swap confirmation, the parties agreed that during the swap pricing call, the rate that appeared on the 19905 screen would be the agreed upon rate for the swap. However, when the swap pricing date grew closer, the head banker became worried that the swap price was going to result in a loss for the bank if the deal were to move forward under the then current market conditions. In order to avoid this, the banker developed a plan with others at the bank and another financial institution.

1 Complaint, *CFTC v. Gorman*, Release No. 8359-21 (February 1, 2021)

2 During the time of this manipulation, he "oversaw the Bank's interest rates business in North America…" Complaint, *CFTC v. Rivoire*, Release No. 8099-19 (December 20, 2019) (all quotes taken from Complaint).

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The Scheme

The head banker stated that the bank needed to "push[] the markets for relevant financial products and 'control[]' the Pricing Call" in an effort to mitigate the loss on the upcoming swap. To achieve this manipulation, the banker proposed buying Five-Year U.S. Treasuries related to the bond issuance which would ultimately increase the bank's return on the overall deal. Specifically, he explained to the Co-Head of Rates at the bank that traders could "push the [U.S. treasury] market, I mean obviously, a tick or whatever."

To achieve this, the head banker insisted that the bank needed to manage the timing of the pricing call with the governmental issuer so that the bank could control the time that the price was called from the 19905 screen. According to the banker and others, the issuer was "just innocent," "not professional," "they are just…government people," "not a player in the market" and "would not challenge the rates that appeared on the Broker Screens."

The head banker then reached out to a trader who was directly under his supervision at the bank to formulate a plan to control the screen on the day of the pricing call. To get control of the screen, this trader reached out to another broker firm and told the broker that "I'm going to give you prices and I just need you to move [the screen]." The broker agreed to work with the trader to control the screen on the day of the pricing call.

The Pricing Call

Leading up to the pricing call, the trader, at the direction of the head banker, sold large amounts of Five-Year Basis Swaps at low prices through the broker in an effort to drive the price down on the 19905 screen. While in the short-term, selling these Five-Year Basis Swaps caused the bank to lose money, ultimately, if the price got low enough to be quoted during the pricing call, the bank would make nearly $400,000 from the governmental issuer due to the more favorable rate on the swap for the bank.

On the day of the pricing call, the head banker and the trader stayed in constant communication with the broker to ensure that they got the price down as low as possible for the quote during the call. During the pricing call, the trader continuously yelled at the broker to "get the screen down" and even threatened to stop using the broker for future deals if he was unsuccessful.

Despite many problems with gaining control of the screen, the broker firm "moved the price level in absence of any actual market activity at the Broker Firm and in contravention of the Broker Firm's rules" and reached a price that satisfied the head banker and the bank.

While still on the pricing call asking (and getting) a delay in the pricing, the head banker told the governmental issuer that there was "a latency issue" and "[o]bviously we are not controlling the screen"—a representation that was

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false and misleading since in fact he did, by means of the broker, have control over the screen.

The Context

Simultaneously, the LIBOR manipulation scandal erupted. Set forth below is an overlay of the timing in this case and LIBOR scandal developments:

	INSTANT CASE	LIBOR SCANDAL
June 27	Push US Treasuries Discussion	CFTC and the UK Financial Services Authority (FSA) separately find that Barclays Bank attempted to manipulate interest rates
June 28	–	Barclays' stock price drops by 15%
July 2/3	–	Barclays' Chairman and Chief Executive resign
July 11	Pricing Call	–

The Requested Relief

According to the CFTC, the transaction was ultimately unfair to the governmental issuer who did not have access to the 19905 screen and was unaware of the head banker's manipulative scheme with the broker firm.

As a result of the head banker's actions, the CFTC is seeking injunctive relief against the banker and certain participants, and civil monetary penalties against the banker under the CEA and CFTC regulations.

General Rules and Regulations

In connection with any swap, commodity contract or futures contract, it is unlawful for a swap dealer to intentionally or recklessly:

- use a manipulative device, scheme or artifice to defraud
- manipulate the price of such instruments
- make any untrue or misleading statement of a material fact or omit to state a material fact necessary to make the statements made not untrue or misleading[3]

3 See 17 Code of Federal Regulations (CFR) §§180.1 and 180.2 (2011) promulgated by the CFTC.

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The actions alleged in both the *Rivoire* and *Gorman* cases, if true, would violate these CFTC rules.

Requisite Material Disclosures

Prior to entering into an over the counter (OTC) swap, a swap dealer must disclose (other than to another swap dealer)[4] material information concerning the swap in a manner reasonably designed to allow the borrower counterparty to assess:

- material risks (e.g. market, credit, liquidity, foreign currency, legal and operational)
- material characteristics including:
  - material economic terms
  - terms relating to swap operation
  - rights and obligations of the parties under the swap
- material incentives and conflicts of interest including:
  - price and mid-market mark
  - compensation or other incentives from any source
- scenario analysis
  - notify borrower counterparty that it can request such an analysis to assess its potential exposure
  - then, upon request, provide such an analysis over a range of assumptions including severe downside stress scenarios that would result in a significant loss
  - disclose all material assumptions and explain the calculation methodologies
  - in designing said analysis, consider any relevant analyses that the swap dealer undertakes for its own risk management purposes[5]

In addition, for swaps not required to be cleared, that the borrower counterparty may elect to require clearing of the swap. [6]

Suitability

A swap dealer that recommends a swap must:

- undertake reasonable diligence to understand the potential associated risks and rewards
- have a reasonable basis to believe that the swap is suitable for the borrower counterparty (which includes the ability to absorb associated potential losses) [7]

4 This is a general exception to the rules.

5 *See* 17 CFR §23.431 (2012) promulgated by the CFTC.

6 *See* 17 CFR §23.432.

7 *See* 17 CFR §23.434.

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Fair Dealing

Generally, communications between swap dealers and borrower counterparties are required to be done in a fair and balanced manner.[8] This is to be based upon principles of fair dealing and good faith.[9]

Additional Special Federal/State/Local Governmental Counterparty Rules

General

With respect to 'special entities,' there are further swap dealer, as well as financial advisor, requirements. 'Special entities' include, among others:

— a Federal agency

— a state, state agency, city, county, municipality or other political subdivisions of a state, or any instrumentality, department or corporation of, or established by, a state or political subdivision

— an employee benefit plan

— a governmental plan under ERISA

— an endowment including foundations[10]

A swap dealer acts as an advisor to a special entity when a swap dealer recommends a swap that is tailored to the particular needs or characteristics of the special entity. [11]

In this case, the swap dealer has a duty to make a reasonable determination that the swap is in the best interests of the special entity.[12] Special entity information that a swap dealer should review in making its recommendation includes:

— financial status

— future funding needs

— hedging, investment or financing objectives

— experience entering into swaps, generally, and swaps of the type/ complexity being recommended

— financial capability to withstand changes in market conditions during

8 *See* 17 CFR §23.433.

9 *Id.*

10 *See* 17 CFR §23.401(c).

11 *See* 17 CFR §23.440(a).

12 *See* 17 CFR §23.440(c).

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the term of the swap[13]

MSRB Rules/Guidance

General

The Municipal Securities Rulemaking Board (MSRB) was established by Congress and charged with a mandate to protect municipal securities investors, municipal entitles and the public interest.[14] The creation of the MSRB was precipitated by New York City's fiscal crisis in the 1970's.

MSRB Rule G-17 requires dealers and municipal advisors to deal fairly with all persons and not to engage in any deceptive, dishonest or unfair practice. Though most often cited in connection with duties owed by dealers to investors, this rule also applies to dealers' interactions with 'municipal entities.'[15]

Generally, all MSRB rules must be approved by the Securities and Exchange Commission (SEC) before becoming effective.

Applicability[16]

'Municipal entities' means any state, political subdivision of a state or municipal corporate instrumentality of a state including (a) any agency, authority or instrumentality of a state, political subdivision or municipal corporate instrumentality, (b) any plan, program or pool of assets sponsored or established by a state, political subdivision or municipal corporate instrumentality or any agency, authority or instrumentality thereof, or (c) any other issuer of municipal securities.[17]

Rule G-17 originally related to the underwriting of municipal securities but, with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in 2010, MSRB was expressly directed by Congress to protect municipal entities as outlined below.

It specifically addressed 'complex municipal securities financings,' which includes, but is not limited to, variable rate demand obligations ("VRDOs") and financings involving derivatives such as swaps.

13 *Id.*

14 'The Role and Jurisdiction of the MSRB' issued in 2018 by MSRB.

15 *See* 'Interpretive Notice Concerning Application of MSRB Rule G-17 to Underwriters of Municipal Securities,' dated August 2, 2012 (the "Rule G-17 Interpretive Notice").

16 *Id.*

17 *See* Securities Exchange Act §15B(g).

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Best Interests[18]

If a swap dealer recommends a swap to a municipal entity, the swap dealer must reasonably determine that the swap is in the best interests of the municipal entity and tailored to its needs or characteristics.

If not serving in the municipal entity's best interest, it must disclose this to the municipal entity[19] and refrain from providing 'opinions' as to the swap. In this instance, the swap dealer must have a reasonable basis to believe that the special entity has a qualified independent representative (QIR) or fiduciary.

Advisor Requirement[20]

An advisor to a municipal entity must have sufficient knowledge to evaluate the transaction and risks of the swap, and is independent of the swap dealer. In general, a QIR is independent if it has not associated with the swap dealer within the past year and was not recommended by the swap dealer.

Generally, MSRB rules require municipal advisors to meet professional qualification requirements, deal fairly with clients and not engage in any deceptive, dishonest or unfair practice. Municipal advisor recommendations must be suitable to the municipal entities. Municipal advisors must disclose, in writing, all material conflicts of interest, and any legal or disciplinary event that is material. Most QIRs are also subject to regulatory requirements of the CFTC and/or SEC.

Requisite Material Disclosures[21]

Consistent with the general rules, for complex municipal securities financings, dealers must disclose:

— the material financial characteristics

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18 *See* 'Regulatory Framework for Municipal Market Derivatives' issued by the MSRB in 2018 (the "2018 MSRB Regulatory Guidance") which interprets 17 CFR §§23.440 and 23.450.

19 For example, (i) Schedule 4 to the ISDA DF Supplement waives the swap dealer's duty to recommend swaps that are in the best interests of the municipal entity, thus relieving the swap dealer of its regulatory duties and (ii) ISDA March 2013 DF Protocol addresses swap dealer clearing requirements. However, any municipal entity may negotiate bilateral amendments to its master agreement with terms that it believes are more appropriate or favorable to it even though banks often tell borrower counterparts that the supplied swap documents are 'industy-standard' and not really subject to negotiation.

20 *See* 2018 MSRB Regulatory Guidance.

21 *Id.*

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— the material financial risks[22]

Such disclosures must address the specific elements of the financing, rather than being general in nature.

Conflicts of interest must also be disclosed. These including compensation from third parties, such as the providers of derivatives and investments (including affiliates of the dealer) which colors the dealer's judgement and causes it to recommend products, structures and pricing levels to a municipal entity that it would not have done so absent such payments.

Suitability

The level of disclosure, as well as its suitability, may vary according to (i) the municipal entity's knowledge or experience with the complex municipal securities financing, (ii) capability of evaluating the related risks and (iii) the financial ability to bear the risks of the financing.

Fair Dealing

As with the general rules, a dealer must not misrepresent or omit the facts, risks, potential benefits or other material information undertaken with a municipal entity in its securities financings.[23]

Conclusion

One of the troubling aspects of the manipulations outlined in the *Rivoire* and *Gorman* cases include that the borrower counterparties are governmental entities, though not in the municipal market. Another point of consternation is that manipulated pricing involved not only junior people at the subject banks, but senior bankers in trading/derivatives.

The eruption of the banking scandals during the Great Recession led to the adoption of Dodd-Frank in 2010. Subsequently, the CFTC, SEC and MSRB adopted rules and regulations in 2011 and 2012 to better protect all borrower counterparties with a special emphasis on municipal entities.

At least from my experience, these protective measures have not, in practice,

22 For VRDOs, such risks include replacement risk for associated liquidity or credit facilities. For swaps recommended for VRDO transactions, such risks are enumerated under the section entitled 'General Rules and Regulations – Requisite Material Disclosures' above. In addition, the dealer must also inform the municipal entity that it should consult with other professionals concerning such risks, including an independent financial advisor. Also see 'Additional Special Federal/State/Local Governmental Counterparty Rules - MSRB Rules/Guidance – Advisor Requirements' above.

23 *See* the section entitled 'General Rules and Regulations – Fair Dealing' above.

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been implemented by the banks, nor have there been sufficient measures undertaken by the banks to assure continuing compliance, certainly not with respect to conduit borrowers (e.g. colleges, hospitals) which are also covered by the foregoing rules.

More troubling, there has historically been only sporadic enforcement by the CFTC, SEC and MSRB to assure that these worthwhile rules and regulations are being followed.

With recent efforts announced by MSRB, and the Securities Industry and Financial Markets Association (SIFMA), to focus on updating outdated guidelines and revising model disclosure documents for risk disclosures, we hope that the protective features of the existing rules and related guidance from nearly a decade ago stay in place and now become subject to more rigorous enforcement.

If not, the derivatives markets will continue to have “a latency issue.”