Bloomberg View

WALL STREET

Banks Will Keep Doing FX Stuff That Got Them in Trouble

MAY 21, 2015 4:14 PM EDT

By Matt Levine

aA

I mentioned yesterday that, as a condition of their probation, all the banks that pled guilty to a conspiracy to rig foreign-exchange rates have to send sad little "Disclosure Notices" to their clients. Here, for instance, is JPMorgan's disclosure notice, which on a cursory glance seems to be identical to the one attached to its plea agreement. It's an interesting little document. There's an introductory paragraph, and then a paragraph of contrite moaning that "conduct by certain individuals has fallen short of the Firm's expectations," specifically by being a massive antitrust conspiracy.

Then there are three bullet points describing other naughtiness that does not rise to the level of antitrust conspiracy. Those bullet points begin:

> "We added markup to price quotes using hand signals and/or other internal arrangements or communications."
>
> "We have, without informing clients, worked limit orders at levels (i.e., prices) better than the limit order price so that we would earn a spread or markup in connection with our execution of such orders."
>
> "We made decisions not to fill clients' limit orders at all, or to fill them only in part, in order to profit from a spread or markup in connection with our execution of such orders."

You might read these sentences as admissions of guilt, or disclosures of crimes, or even apologies. In context -- in the context of a disclosure notice sent to clients as part of the bank's probation for a felony conviction, one paragraph after the apology for the massive antitrust conspiracy -- that's kind of what they look like. And in the banks' plea agreements, the practices described in those bullet points are listed as "other relevant conduct" for the criminal conspiracy. So I read the bullet points as confessions yesterday, and was puzzled because, while they seem like sharp practices, they don't quite seem like crimes.

But those bullet points are actually introduced by the phrase, "The Firm has engaged in other practices on occasion, including:." These are not crimes, just "practices." And the disclosure notice just describes them. It stops after the bullet points. It never says "and those practices were wrong." Or "and we're sorry we did those things." Or even: "and we'll stop doing them."

Because they won't! Here's another letter that JPMorgan is sending to its clients along with the disclosure notice. This one is not a condition of its probation. Here's how it starts:

> The purpose of this letter is to clarify the nature of the trading relationship between you and the Corporate & Investment Bank at JPMorgan Chase & Co. and its affiliates (together, "JPMorgan" or the "Firm") and to disclose relevant practices of JPMorgan when acting as a dealer, on a principal basis, in the wholesale spot foreign exchange ("FX") markets. We want to ensure that there are no ambiguities or misunderstandings regarding those practices.

So: *That does not sound like an apology*. That sounds downright feisty. The disclosure notice, which JPMorgan has to send, starts with an apology and then goes on to list some things that JPMorgan did in the past. The client letter, which JPMorgan *wants* to send, starts with a defiant "no ambiguities or misunderstandings" and then goes on to list some things that JPMorgan will keep doing in the future.

Did you guess that they're the same things? Of course you did! (Minus the antitrust conspiracy of course.)

So the Justice Department didn't like that JPMorgan, and most of the FX-manipulating banks, "added markup to price quotes using hand signals and/or other internal arrangements or communications." So JPMorgan has to say to clients:

> In certain instances, certain of our salespeople used hand signals to indicate to the trader to add markup to the price being quoted to the client on the open telephone line, so as to avoid informing the client listening on the phone of the markup and/or the amount of the markup.

The idea here is that clients wanted to get a price directly from the trader, thinking that that might be an "objective" or "best" price, without the salesperson's added markup. So they'd make the salesperson talk to the trader while the client was on the phone, so the client could hear what the trader said. But the clients' phones don't have video, and meanwhile the salesperson was frantically pantomiming "ADD A BIG MARKUP" to the trader.

Here's how JPMorgan removes ambiguity today:

> Unless otherwise agreed, any firm or indicative price quoted by JPMorgan to a counterparty is an "all-in" price, inclusive of any markup above the price at which JPMorgan may be able to transact, or has transacted, with other counterparties, **regardless of the circumstances under which a counterparty receives or overhears a price**. JPMorgan's sales and trading personnel are not obligated to disclose the amount of revenue JPMorgan expects to earn from a transaction, nor are they required to disclose the components of JPMorgan's all-in price. While we do not have any duties to disclose to a counterparty any mark-up included in the order price, we will be truthful with the counterparty if we make a disclosure about whether and how much markup is included in the price.

Emphasis added. JPMorgan is making clear here that, if you demand an open line so you can hear the quote directly from the trader, the salesperson might still be doing an interpretive dance on the theme of Add Two Pips To The Offer For This Guy. And again:

> It should be expected that JPMorgan's sales, trading and other personnel will consult, including with respect to a counterparty's interests, trading behavior and expectations, markup, spread, and any other relevant factors, on a need-to-know basis in order to manage JPMorgan's market-making positions, and for the benefit of JPMorgan's trading positions and the handling of other counterparty transactions.

Of course salespeople and traders talk to each other! The salesperson's job is to help the trader understand how to price a trade *for a particular client*. If the salesperson thinks it's in the bank's interest to add a markup -- that is, if the salesperson thinks that the client is not particularly price-sensitive and will not trade away if the price is too high -- then the salesperson's job is to inform the trader. Obviously the client's job is to prevent the salesperson from informing the trader. It's a competitive game. And obviously JPMorgan's job -- now -- is to inform the client that this is a game its salespeople intend to win. Despite the recent setbacks with the Justice Department.

Or there's the limit order thing. From the second bullet point of the disclosure notice:

> For example, if we accepted an order to purchase €100 at a limit of 1.1200 EURUSD, we might choose to try to purchase the currency at a EURUSD rate of 1.1199 or better so that, when we sought in turn to fill the client's order at the order price (i.e., 1.1200), we would make a spread or markup of 1 pip or better on the transaction.

And the third:

> For example, if we accepted a limit order to purchase €100 at a EURUSD rate of 1.1200, we would in certain instances only partially fill the order (*e.g.*, €70) even when we had obtained (or might have been able to obtain) the full €100 at a EURUSD rate of 1.1200 or better in the marketplace. We did so because of other anticipated client demand, liquidity, a decision by the Firm to keep inventory at a more advantageous price to the Firm, or for other reasons.

This would be a no-no for a stockbroker, who acts as an agent purchasing stock for the client. If you are working a client limit order as an agent, you have a duty of best execution to pass on the best price to the client, even if it's below the limit price, and if you can get the stock at the limit price but not below it, then you need to try to fill the client's order. In foreign-exchange trading, where banks operate as principals (trading with the clients) rather than as agents (executing on behalf of clients), JPMorgan -- and all the other FX manipulator banks -- seem to have thought that they had a rather weaker duty of best execution, and were not required to fill a limit order if it wouldn't be profitable for them.

Guess what? They still think that!

> When JPMorgan is willing to work a counterparty's "order" (as such term is used herein) at a price (such as a limit order), JPMorgan is indicating a willingness to attempt to enter

> into the trade at the price requested by the counterparty. Unless otherwise specifically agreed, JPMorgan will exercise its discretion appropriately in deciding whether to work an order, which orders it would be willing to execute, when it would be willing to execute them, and how it would execute them, including whether to execute all or part of the order unless we have otherwise expressly agreed to different terms of execution. As such, JPMorgan's receipt of an order or any indication of working an order received from a counterparty does not create a contract between the counterparty and JPMorgan that commits the Firm to execute any or all of the order in any particular way.

I don't mean to pick on JPMorgan here; I just happened to see its client letter first. These are universal practices, and it looks like they will continue universally. Now they will just be explained a little better. Here is Barclays's very similar client letter, which starts a bit less defiant but is substantively very similar. (I suspect that the substance of these letters was negotiated among the banks, and with regulators and prosecutors.) Here is RBS's.

These letters are amazing documents. Whenever a wave of bank scandals breaks -- mortgage-backed securities, Libor, FX, "bond lies" -- an important theme is always the mutual incomprehension of regulators and the public, on the one hand, who find the banks' behavior obviously abhorrent, and the banks, on the other hand, who are like, "What? This? We've done this forever. We thought it was fine." By this point we know how that tension is always resolved: The regulators are always right, the banks are always wrong, and the banks agree to pay big fines and install monitors and so forth. But the banks always go off and grumble that things weren't as bad as all that, and that it's unfair to be punished retroactively for doing things that everyone thought were fine.

Here they're doing that grumbling in letters to clients *the day after their guilty pleas*. There is no promise of reform here: The Justice Department caught the banks doing things that it didn't like and fined them billions of dollars, but won't stop them from doing most of those things. As long as there are no more ambiguities or misunderstandings about what they are. It's a weird stalemate. The Justice Department doesn't like these practices, the banks like them fine, and they've agreed to disagree. These practices have been singled out, in the context of criminal plea agreements (a bad context!), as things that *happened*. But not quite as *crimes*. And the banks are careful to make clear: They're going to keep happening.

1. *Hahaha no really, it's actually a condition of their probation. See, e.g., page 10 of the JPMorgan plea agreement. They'll have a probation officer and everything.*

2. *It's on the website, and my understanding is that it's also being sent to clients. On the website it's lumped together with the required disclosure notice, suggesting that they're being sent together.*

3. *I mean. The letter does say this:*

   > *However, a counterparty should understand that JPMorgan makes use of information provided to it as principal in order to effectuate and risk manage transactions. Specifically, unless otherwise agreed, JPMorgan may use the economic terms of a transaction (but not the counterparty identity) in order to source liquidity and/or execute risk-mitigating transactions.*

   And some of what went on in the antitrust conspiracy could, at a high level, look exactly like use of client economic terms "to source liquidity and/or execute risk-mitigating transactions."

4. *It's in the Barclays, Citi, JPMorgan and UBS plea agreements, and gets a lot of prominence in the UBS one. Royal Bank of Scotland seems to have skipped the hand signals.*

5. *Especially for that very punchy "overhears." Why are you eavesdropping, clients?*

6. *As I said yesterday:*

   > *The whole* **point** *of a salesman is to help a trader understand how aggressive she should be in pricing for a client. Some clients will do everything in competition and fight for every last basis point. Some clients will take whatever price the bank gives them. The salesman tells the trader which clients are which, so the trader knows how to price trades to win the aggressive ones and make money on the complacent ones.*

7. *The limit order stuff is in the attachments to all the plea agreements (even RBS's, though RBS has only the second bullet point, not the third). UBS's plea agreement doesn't have that attachment, but the conduct is described in more detail on page 7 of Exhibit 1 to the UBS plea:*

   > *Prior to, and continuing after the NPA, UBS accepted limit orders from FX customers. A limit order is an order to buy or sell a currency pair when the market hits a price specified by a customer. The key components of a limit order are the price and timing of execution. After accepting limit orders at a certain price, UBS personnel would (unbeknownst to the customer) "track" or "work" certain limit orders or portions of limit orders at a price level different from that specified by the customer—often differing by a small number of pips—to add an undisclosed markup. On those occasions where the market hit both the customer's specified limit price and UBS's altered price, this practice resulted in UBS obtaining an undisclosed markup, and also may have resulted in a delay in executing the customer's order. If the market hit the customer's limit price but not UBS's altered tracking price, this practice subjected customers to a risk that their limit orders would not be filled, or at a minimum that the fill of their limit orders would be delayed. The practice of tracking and executing limit orders*

> *at a level different from the customer's level occurred throughout UBS's FX trading and sales desks. One illustrative example follows:*
>
> *On July 17, 2013, a UBS FX salesperson based in Stamford sent the following email to colleagues on UBS's London and Singapore FX desks: "Please note that [customer] has an order to buy EUR 150 mio at 1.3070. I split the trade into three pieces; EUR 50 mio flat = 1.3070, EUR 50 mio at 1.3069 and EUR 50 mio at 1.3068." Later in the same email, the UBS FX salesperson added, "If he trades, I would like you to try and take two pips. . . Three would be even better, but I'll leave that up to you."*

8. *Individual criminal convictions, on the other hand, are harder to come by, in part because much of the time everyone at the banks really did think their conduct was fine and so lacked a certain amount of fraudulent mens rea. This comment is in a footnote because it's a fairly controversial view, and is clearly wrong in many specific instances. Like, if you're in your Libor chat room talking about going to jail, come on.*

This column does not necessarily reflect the opinion of Bloomberg View's editorial board or Bloomberg LP, its owners and investors.

To contact the author on this story:
Matt Levine at mlevine51@bloomberg.net

To contact the editor on this story:
Zara Kessler at zkessler@bloomberg.net