Market Abuse Case Studies

Neil Phillips (Glen Point Capital LLC) FX market manipulation

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007	Neil Phillips (Glen Point Capital LLC)
Offence: Manipulating the FX Market to hit a barrier option	**Civilian Authority:** U.S. Department of Justice

TradingHub

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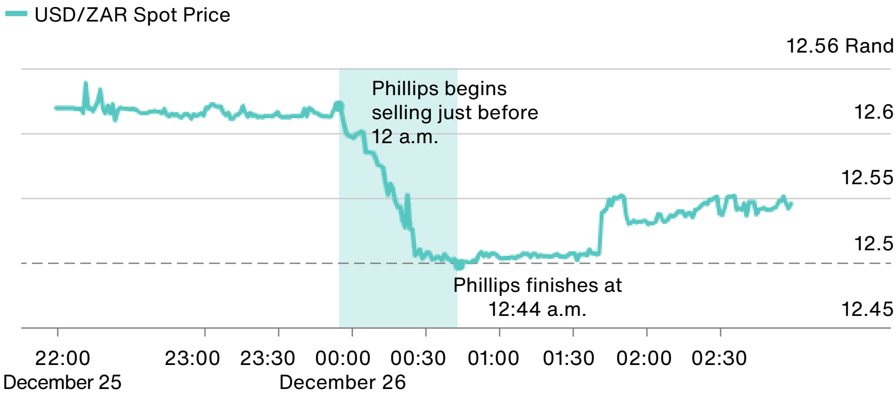
Overview of the facts

Neil Phillips the co-founder and CIO of Glen Point Capital, was found guilty of commodities fraud by a jury in federal court in Manhattan after a weeklong trial. Glen Point was a UK based global "macro" fund that focused on emerging markets, FX markets, and currency and commodity products. Glen Point was a registered commodity pool operator with the Commodity Futures Trading Commission (CFTC) and Phillips was himself registered with the CFTC as well.

In late October 2017, Phillips purchased a "one touch" digital option for USD/ZAR from a U.S. investment bank that was set to expire on January 2, 2018. The option had a notional value of $20 million and a barrier rate of 12.50 ZAR to USD. Under the terms of the digital option, if the USD/ZAR exchange rate went below the rate of 12.50 at any point prior to January 2, 2018, Phillips (trading on behalf of Glen Point Capital) would be entitled to a $20 million payment.

When Phillips purchased the digital option, the USD/ZAR exchange rate was over 14.00 and remained above 12.50 until the early hours of December 26, 2017 (Boxing Day) when USD/ZAR fell slightly below 12.50 before recovering thereafter. As a result of the USD/ZAR exchange rate falling below 12.50, the "one-touch" digital option was triggered, and Phillips was entitled to receive $20 million.

The movement of USD/ZAR below 12.50 occurred immediately after Phillips purchased ZAR vs. USD amounting to $725 million. These purchases and the USD/ZAR spot FX rate are shown in the graph below.



Source: Bloomberg, US SDNY
Note: Time is GMT.

The United States Attorney for the Southern District of New York charged Phillips with directing $725 million in trades on December 26, 2017, to artificially manipulate the United States dollar (USD) / South African rand (ZAR) exchange rate to fraudulently trigger a $20 million payment under a barrier options contract. Phillips was arrested in Spain at the request of the United States.

In case law[1], the "elements of a market manipulation claim under section 9(a) are: (1) the defendant possessed an ability to influence market prices; (2) an artificial price existed; (3) the defendant caused the artificial price; and (4) the defendant specifically intended to cause the artificial price".

In the case of digital / barrier options the market risk profile (e.g. greeks such as the delta) can swing very substantially especially in cases where the barrier is close and / or the option is close to expiry. These characteristics mean that proving the trader's intent can be difficult. Phillips claimed during the case that he had a bullish view on ZAR and expected the digital option to be triggered imminently. He claimed that the purchase of $725 million of ZAR was simply to maintain a long market risk position in ZAR after the digital option had been triggered.

In the end, the jury deliberated for less than half a day before returning a guilty verdict. Phillips' communications provided strong evidence that Phillips' intention when purchasing $725 million of ZAR was to push USD/ZAR below 12.50 and trigger the payout of the digital option.

Phillips will be sentenced at a later date and faces a maximum of 10 years in prison.

Argument put forward by the state

The prosecution argued that with the $20 million One Touch Option set to expire in a matter of days, Phillips devised a scheme to intentionally and artificially manipulate the USD/ZAR rate to drive the rate below 12.50 and trigger the $20 Million payment. The prosecution argued that Phillips engaged in this USD/ZAR FX spot trading for the express purpose of artificially driving the USD/ZAR rate below 12.50. The prosecution noted that the price move was artificial given the volume of trading and it was observed that in the hours that followed the completion of the USD/ZAR FX spot trading directed by Phillips, the USD/ZAR rate once again increased and returned to levels above the 12.50 barrier and did not go below that rate for the remainder of the day.

The prosecution noted that during the span of less than an hour between shortly before midnight London time on December 25, 2017 (Christmas day), and approximately 12:45 a.m. London time on December 26, 2017, Phillips personally directed a Singapore-based trader for Nomura to sell, on behalf of Glen Point, approximately $725 million USD in exchange for approximately 9,070,902,750 ZAR. During that one-hour period, Phillips, through his trading, caused the USD/ZAR rate to fall substantially until the rate went just below 12.50. As soon as Phillips had achieved his objective and the USD/ZAR rate fell below 12.50, he immediately directed that the trader at Nomura cease trading.

Additionally, the prosecution presented evidence of Phillips providing trading instructions through Bloomberg chat messages. In these chat messages, Phillips explicitly directed the Nomura trader to continue

[1] AMARANTH NATURAL GAS COMMODITIES LITIGATION, United States District Court, S.D. New York. Apr 27, 2009

selling until the USD/ZAR rate fell below 12.50 and expressly stated that his purpose in directing these trades was to drive the USD/ZAR rate below 12.50 stating, “my aim is to trade thru 50,” “[n]eed it to trade thru 50. 4990 is fine,” and “[g]et it thru.” As well as chats in which Phillips discussed how “to break 50”. Prosecutors also played an earlier phone conversation in which Phillips told one of the Glen Point traders that he might need him “to start f*cking around in dollar/rand tonight.”

Once Phillips was informed by the trader at Nomura that the USD/ZAR had traded at below 12.50, he immediately instructed the Nomura trader to “stop” trading and asked for proof “of the print.”

Argument put forward by the defendant

The defence presented evidence that Phillips, who was born and raised in South Africa, was pursuing a strategy based on a strong belief that the rand would rise once Cyril Ramaphosa emerged as the country’s presumptive next president after the African National Congress election on December 18, 2017. Phillips’ lawyers argued that the “Boxing Day Trades” were motivated by this strategy, not the $20 million option.

Following a ruling from U.S. District Judge Lewis Liman that the jury could consider evidence regarding common practices in FX trading, Phillips' defence was able to present former JPMorgan Chase trader Andrew Newman as an expert witness to assert that such trading practices are industry standard. During the course of his testimony the defence asked Newman, “[B]ased on that analysis what, if any, opinions did you form about trades on December 26, 2017?” and Newman responded, “Glen Point’s trading on that was part of a delta replacement strategy for the anticipation of the expiration of the 12.50 one touch option expiring on January 2." Newman also testified that it would have been consistent with industry practice for the U.S. bank who sold the option to Phillips “to reduce its risk by entering trades that would have profited from the decline in USD/ZAR”.

Judge Liman, also ruled that the jury could hear evidence related to the dollar-rand trades executed by the bank who sold the option, which the defence claims were intended to defend the barrier (and thus prevent it being touched). A week before Phillips executed the “Boxing Day Trades” the U.S. bank who sold the option offered to buy the option back for $13 million. Graeme Henderson, a London-based foreign exchange broker with JB Drax, was the first witness called to the stand by the federal prosecutors. Drax was the intermediary through which Glen Point bought the $20 million option. Under questioning by the defence, Henderson said that the bank offered to buy back the option on December 18, 2017, starting with an offer of $9 million. Three hours later, the bank said it was willing to pay $13 million. Glen Point declined both offers, Henderson testified.

The defence introduced Drax’s testimony to further their argument that Phillips had a lawful trading strategy to which he was committed and which his counterparty anticipated, as shown by the fact that the bank was eager to unwind the option, even at a steep loss. This was also part of the defence’s argument that barrier trading is standard industry practices and that the bank itself engaged in a strategy to defend the barrier.

Henderson testified that banks often actively trade as currencies approach option barriers. “They’re going to reduce the risk of them not being hedged,” he said. “There’s a lot of increased hedging activity as the barrier gets closer.”

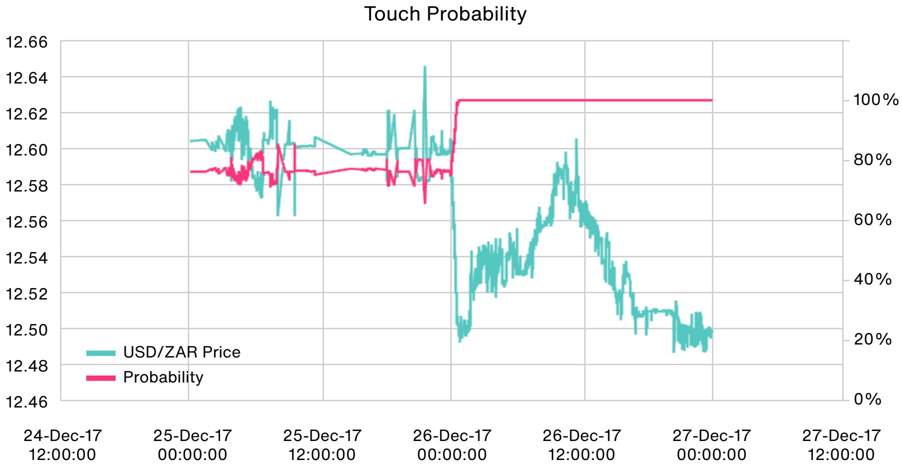
TradingHub’s analysis

As discussed above, for Phillips to be found guilty of market manipulation the prosecution needs to prove all four of the elements for a market manipulation claim. This case focused largely on the fourth element, whether Phillips intended to move the price of USD/ZAR to drive the rate below 12.50 and trigger the $20 million payment, or to legitimately offset the risk of the barrier option not getting triggered.

Phillips own defence and the testimonies of the witnesses that his defence called was that his trading activity was legitimate delta hedging.

In the graph below we have plotted the evolution of USD/ZAR and the probability of the option getting triggered. The probability is based upon:

- The distance from the barrier to spot
- The amount of time left before expiry
- The volatility



The graph shows that as ZAR strengthens (USD/ZAR weakens) (turquoise price line) the probability of the option being triggered increases (pink line). In the hours prior to Phillips' trades and the option triggering the probability increases above 80%. This high probability supports Phillips’ assertion that he expected the option to be triggered. Of course, the counter argument to this is that the probability of the barrier being hit increased because the spot rate fell... and that the spot rate fell because Phillips caused it to.

There is essentially a chicken and egg problem; did Phillips trade because the market moved or did the market move because Phillips moved it.

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