

PRIMARY MARKET MANIPULATION

An Emerging
Surveillance Risk



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Until recently, the focus on monitoring market abuse has been applied almost exclusively to trading in the secondary markets. This is the space where vendors have focused their attention and where the biggest, most eye-catching fines and prison sentences have been levied by regulators and prosecutors.

However, over the last couple of years, there has been a notable series of important regulatory complaints and prosecutions brought against alleged market abuse related to the primary markets. These have not received the attention that they merit either from the vendor community or the surveillance teams in financial institutions; we believe that this needs to be addressed.

In this series, we will focus on four such cases and demonstrate why there are significant risks in this arena and why surveillance teams need to concern themselves with the detection of abuse in the primary market space.

Primary vs Secondary Markets

At the risk of stating the obvious, let's be clear about what we mean by primary and secondary markets.

The term "capital market" refers to any part of the financial system that raises capital from bonds, shares, and other investments. New stocks and bonds are created and sold to investors in the primary capital market, while investors trade securities in the secondary capital market.

As such, secondary market transactions involve the day-to-day trading of stocks, bonds, futures, commodities, FX, and OTC derivatives. These can be traded on a variety of venues (including exchanges) and/or over the counter.

Primary market transactions involve issuing new shares or bonds to raise funds for companies, governments, and public sector institutions. When these shares or bonds are first sold to the public markets, the issuer will often simultaneously enter into other trades, such as bespoke interest rate swaps or structured FX trades, with the bank leading the transaction. For example, interest rate swaps may be used to hedge the interest rate risk related to debt servicing costs, whilst a

foreign exchange transaction may be required when using the funds to acquire an asset in a cross-border transaction.

Until now, the case studies that we have presented have involved manipulation solely in the secondary markets consisting of:

- U.S. Department of Justice vs. NatWest Markets Plc – Spoofing in U.S. Treasuries.
- Commodity Futures Trading Commission (CFTC); U.S. Department of Justice vs. JP Morgan Chase & Co. - Spoofing in Treasuries and Precious Metal Futures.
- U.S. Department of Justice vs. Deutsche Bank Securities Inc - Spoofing in U.S. Treasury and Eurodollar Futures.

These case studies have typically involved single traders or a small group of traders acting alone to generate profits for their trading book or speed up the recycling of risk.

The nature of most trading mandates is typically that a trader works alone (or as part of a small team) and their activity is isolated to themselves or their group (desk). There is usually relatively little overlap between desks and individuals rarely act in concert, as a result of their individual mandates.

Primary market transactions are very different. In the example of a deal driven by takeover activity, such business can involve series of transactions bringing together many parts of the bank and several trading desks. For example, Bank XYZ advises on the acquisition of a European-based company by a U.S. company. Such a transaction could incorporate:

- The M&A activity itself (generating large fees to the Investment Banking Team).
- Loans or credit facilities (Banking Team).
- Public equity issuance (Equity Capital Markets).
- Debt issuance (Debt Capital Markets).
- Structured and/or deal contingent interest rate swaps (various trading desks within a FICC business).
- Structured and/or deal contingent foreign exchange (FX Business).

Even relatively straightforward fixed rate bond issuance will often involve an interest rate swap used to convert the fixed rate coupons that the client is paying into a more convenient floating rate. Such swaps can be extremely large in size and, whilst bespoke and therefore unique, will need to be hedged using a combination of standard, secondary market derivatives and securities.

The price at which the bank trades these bespoke derivatives will often be determined by reference to the screen price of

the liquid, secondary market hedge instruments at a particular time. If this screen price can be manipulated by the trader, additional profits will arise; potentially a profit which exceeds the fee for leading the primary market offering. As such, the traders involved in our case studies have manipulated, or are alleged to have manipulated, prices in the public markets in order to create additional profit when they enter into the private (primary market) derivatives.

The nature of primary market deals (and the potential rewards) means that winning such mandates requires a coordinated effort across many departments and will often include the client meeting extremely senior managers in the bank. If the transaction is important enough, the bank CEO may even meet the prospective client. Any abuse that arises in such a transaction can, therefore, produce enormous reputational damage to the institution and, via legislation such as the FCA Senior Managers Regime in the UK, present acute risks and personal liability to everyone involved.

Manager Personal Liability

Whilst there is not a direct equivalent to the FCA's Senior Managers and Certification Regime in the U.S., the legal standards are broadly the same for "corporate officers" or "controlling persons". Under the Supreme Court-created Responsible Corporate Officer doctrine, a corporate officer may be found criminally liable for regulatory offences even when he or she is unaware of and not involved in the wrongdoing if he or she is in a position of authority regarding the activities giving rise to the illegal conduct and failed to prevent or correct the conduct.

Additionally, both the Securities Act and the Exchange Act impose secondary liability on "controlling persons" for violations of securities laws committed by persons under their control. Generally, "control" for these purposes is held by any officer, director, or employee of a public company who possesses, directly or indirectly, the power to "direct or cause the direction of the management and policies" of the person or entity that is liable for a violation of the securities laws. Section 15 of the Securities Act provides that any person who

controls another person who commits a violation under Sections 11 or 12 of the Securities Act will be jointly and severally liable for the wrongful conduct "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist."

Section 20(a) of the Exchange Act provides that every person who indirectly or directly controls another person found liable for a securities violation under the Exchange Act is jointly and severally liable for that same conduct, "unless the controlling person acted in good faith and did not directly or indirectly induce" the act(s) constituting the violation. Originally, circuit courts were divided on whether the SEC had statutory authority to bring claims under Section 20(a). The Dodd-Frank Act clarified any confusion by amending Section 20(a) to grant clear authority to the SEC to bring monetary and injunctive claims against corporate officers and directors for violations committed by their subordinates.

Temptation

The derivative transactions that primary market activity presents are often huge. The Westpac case study involves the largest interest rate swap in the history of the Australian market (AUD 12bn). Contingent FX transactions have exceeded USD 40bn in size.

The price of such a transaction is often agreed by reference to a screen quote for a liquid (benchmark) instrument, either when the primary transaction is completed or following a call from the client.

Let's consider the example of a deal contingent FX forward. This is an FX forward trade which is settled when and if a related M&A transaction is completed. If the M&A transaction does not complete, the FX forward is cancelled at no cost to the customer. As stated above, such transactions can be huge and have exceeded USD 40bn.

In such a transaction, the price might be set as the price quoted on a particular broker screen plus potentially 0.75 cents. So, if the screen quoted 1.2700 then the transaction would be done at a price of 1.2775. As a guide to the sheer scale of these transactions, in the case of a USD 40bn deal related forward, a price movement of a single pip (i.e., a shift from 1.2700 to 1.2701) would result in a profit of over USD 3,000,000. Given the potential rewards of influencing that screen price, the temptation to trade ahead of the fixing must be extremely strong. The first four case studies that we will present show cases where traders gave in to (or allegedly gave into) that temptation.

Case Studies

Through the case studies, we will discuss the economics behind primary market and M&A driven transactions and how they create opportunities for bad actors to manipulate markets and the blind spots that exist within surveillance solutions. We will dissect four recent enforcement actions and outline why approaching this issue through a risk-based lens offers the only meaningful way to manage the problem.

The case studies are:

- ASIC vs Westpac – Case pending April 2024 – Alleged pre-positioning ahead of a series of interest rate swap transactions to support a prestige transaction, a partial privatisation of NSW's national grid.
- CFTC v Mizuho Americas April 2023 – Deal Contingent FX Forwards – Manipulation took place on the screen price.
- CFTC vs HSBC – April 2023 – Manipulating swap spreads on screen to influence the pricing of issuer swaps.
- CFTC vs John Patrick Gorman III - Alleged manipulation of the pricing of issuer swap.

Market Abuse Case Studies

WestPac Primary Market Manipulation

| | |
|---|--|
| Market Abuse Case Study No: 001 | Name: WestPac Banking Corporation |
| Offence: Front running and insider trading in interest rate derivatives and swaps | Detection Control: Front Running V2 (Deal Specific Facilitation) |

 TradingHub

WestPac Primary Market Manipulation

Market Abuse Case Study No:
001

Name:
WestPac Banking Corporation

Civilian Authority:
The Australian Securities and Investment Commission (ASIC)

Offence:
Front running and insider trading in interest rate derivatives and swaps

Detection Control:
Front Running V2 (Deal Specific Facilitation)

Overview

On the 5th May 2021, the Australian Securities and Investment Commission (ASIC) filed an application with the Federal Court of Australia claiming that on the 20th October 2016, WestPac entered into hundreds of transactions (876) in various Australian dollar Interest Rate Derivatives (IRDs) hours before trading c. AUD 12bn of interest rate swaps with a Special Purpose Vehicle (SPV) being used by a consortium of investors for the purchase of a majority stake in AusGrid (the "Swap Deal").

AusGrid is an electricity distribution company with 1.8 million customers in New South Wales, and the purpose of the interest rate swaps were to hedge floating rate interest rate payments due on loans borrowed by the SPV to part fund the AUD 16.2bn acquisition of 50.4% of AusGrid sold in a part-privatisation by the Government of New South Wales.

The application claims that WestPac took advantage of inside information relating to the AusGrid part-privatisation when trading the various IRDs in advance of the Swap Deal with and without the consortium's knowledge.

ASIC's grounds for proceedings

There are three critical grounds to ASIC's proceedings which are that:

- WestPac committed 876 cases of insider trading because it possessed inside information relating to the AusGrid transaction and took advantage (without the consortium's consent or knowledge) of this information via 876 IRD transactions.
- WestPac's 876 IRD transactions likely influenced the execution price of the Swap Deal (contravening 12CB of the ASIC Act).
- WestPac did not do all things to ensure that the Swap Deal was executed efficiently, honestly, and fairly (contrary to section 912A of the Corporations Act).

Transaction details & alleged harm

The Swap Deal comprised of 11 interest rate swaps totalling c. AUD 12bn in notional amortising over a 10-year period. These swaps involved WestPac paying a floating rate in return for a fixed rate from the consortium's SPV. The purpose being to transform the consortium's debt servicing costs on syndicated debt funding into fixed cashflows.

Prior to execution, WestPac had agreed with the consortium's SPV to price the swap deal using a formula that referenced the prevailing market levels of related financial products plus an execution margin.

The goal of the formula was to ensure that the price of the Swap Deal occurred at a level consistent with market levels prevailing at

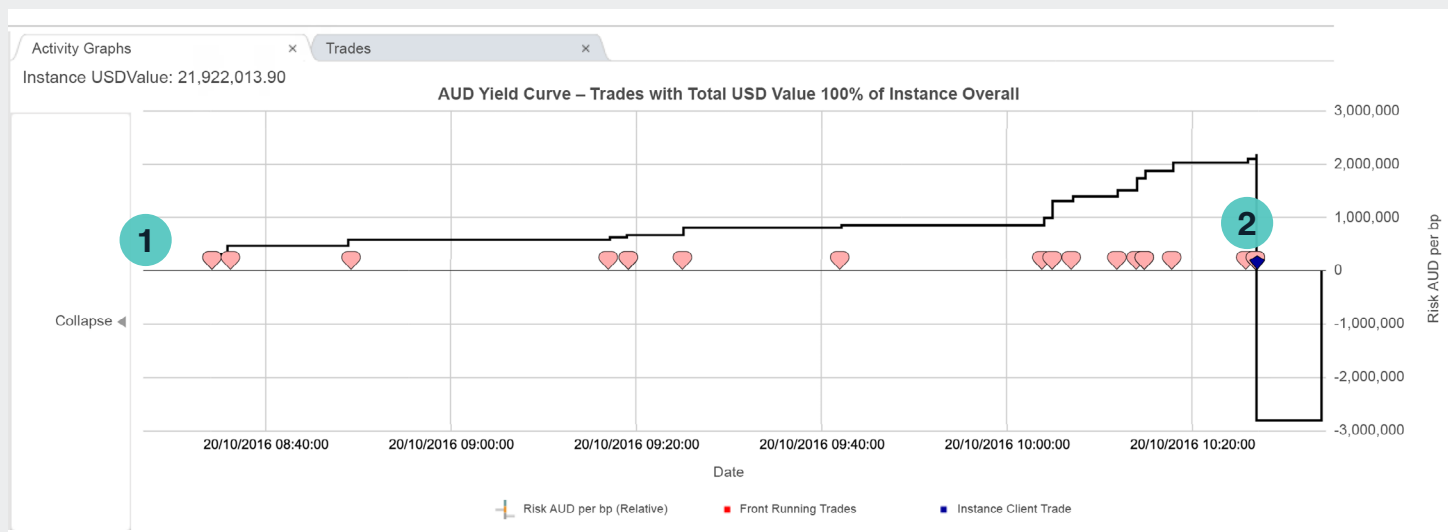
the precise time that the Swap Deal was executed (10:27 am AEST). Furthermore, it incorporated an execution margin to cover WestPac's hedging costs and a reasonable profit on the transaction.

It is alleged that WestPac began to hedge the Swap Deal before it had been priced and executed via the 876 IRDs. These IRDs comprised of:

- Sells of 692 Australian government bond futures contracts (totalling AUD 3.59bn 3-year & AUD 818.9m 10-year contracts).
- Sells of 128 Australian dollar 90-day interest rate futures contracts (totalling AUD 6.109bn and expiring in Sep '17, Dec '17, Mar '18 and Sep '18).
- 35 Exchange for Physicals (EFPs) transactions where an aggregate of AUD 3.98bn of short positions in Australian government bond futures were exchanged for 3, 5 & 10-year Australian dollar interest rate swaps (WestPac paying fixed vs. receiving floating).
- 21 Australian dollar 6s3s tenor basis swaps totalling AUD 2.075bn in 5, 7 & 10-year maturities.

These transactions were executed between 8:30 am & 10:27 AEST and appear to have been designed to hedge up to 50% of the interest rate risk originating from the cash flows of the Swap Deal. It is alleged that the market moved detrimentally to the consortium as a direct result of this pre-hedging, and consequently, the quoted rate and execution price of the Swap Deal were subsequently fixed at a worse price to the consortium (and a better price for WestPac) than would otherwise have occurred.

Detecting Primary Market Manipulation in MAST



This scenario has been calculated and run through MAST. The graph screenshot shows how MAST illustrates the changing risk position within the instance.

1. The line graph and associated red markers show the build-up of the interest rate risk position from the bond futures trades during the pre-hedging activity.
2. The consortium trade is highlighted by a blue diamond and shows a corresponding fall in the interest rate risk position when the Swap Deal is executed at 10.27 am AEST.

Activity Graphs

Trades

Show Relevant Trades

Show All Trades

| Trade Date | Client Instrument ID | USDValue ? ▼ | Trade Designation ? | Amount |
|---------------------|----------------------|---------------|---------------------|------------------|
| 20/10/2016 08:34:00 | AUD 3Y Bond Future | 2,833,229.40 | WestPac Trades | 600,000,000 |
| 20/10/2016 08:34:00 | AUD 3M Bond Future | 87,181.72 | WestPac Trades | 2,000,000,000 |
| 20/10/2016 08:34:00 | AUD 3M Bond Future | 28,729.37 | WestPac Trades | 664,000,000 |
| 20/10/2016 08:34:00 | AUD 3M Bond Future | 85,893.28 | WestPac Trades | 2,000,000,000 |
| 20/10/2016 08:36:00 | AUD 3Y Bond Future | 1,841,148.10 | WestPac Trades | 500,000,000 |
| 20/10/2016 08:49:00 | AUD 10Y Bond Future | 1,395,923.49 | WestPac Trades | 100,000,000 |
| 20/10/2016 08:49:00 | AUD 3M Bond Future | 3,401.93 | WestPac Trades | 109,000,000 |
| 20/10/2016 09:17:00 | AUD 10Y Bond Future | 154,603.51 | WestPac Trades | 10,000,000 |
| 20/10/2016 09:19:00 | AUD 10Y Bond Future | 303,257.26 | WestPac Trades | 20,000,000 |
| 20/10/2016 09:19:00 | AUD 10Y Bond Future | 480,362.22 | WestPac Trades | 33,600,000 |
| 20/10/2016 09:25:00 | AUD 3Y Bond Future | 1,930,569.94 | WestPac Trades | 500,000,000 |
| 20/10/2016 09:42:00 | AUD 3M Bond Future | 118,161.83 | WestPac Trades | 1,336,000,000 |
| 20/10/2016 10:04:00 | AUD 3Y Bond Future | 3,229,274.57 | WestPac Trades | 490,200,000 |
| 20/10/2016 10:05:00 | AUD 3Y Bond Future | 4,246,773.81 | WestPac Trades | 999,900,000 |
| 20/10/2016 10:05:00 | AUD 3Y Bond Future | 300.18 | WestPac Trades | 100,000 |
| 20/10/2016 10:07:00 | AUD 10Y Bond Future | 558,948.51 | WestPac Trades | 69,100,000 |
| 20/10/2016 10:12:00 | AUD 10Y Bond Future | 755,293.15 | WestPac Trades | 100,000,000 |
| 20/10/2016 10:12:00 | AUD 10Y Bond Future | 108,576.73 | WestPac Trades | 15,400,000 |
| 20/10/2016 10:14:00 | AUD 10Y Bond Future | 1,277,736.66 | WestPac Trades | 200,000,000 |
| 20/10/2016 10:15:00 | AUD 10Y Bond Future | 284,135.45 | WestPac Trades | 50,000,000 |
| 20/10/2016 10:15:00 | AUD 10Y Bond Future | 271,364.89 | WestPac Trades | 50,000,000 |
| 20/10/2016 10:15:00 | AUD 10Y Bond Future | 109,539.97 | WestPac Trades | 20,800,000 |
| 20/10/2016 10:18:00 | AUD 3Y Bond Future | 1,078,032.75 | WestPac Trades | 500,000,000 |
| 20/10/2016 10:26:00 | AUD 10Y Bond Future | 254,155.61 | WestPac Trades | 50,000,000 |
| 20/10/2016 10:27:00 | AUD 10Y Bond Future | 247,327.78 | WestPac Trades | 50,000,000 |
| 20/10/2016 10:27:00 | AUD 10Y Bond Future | 238,091.79 | WestPac Trades | 50,000,000 |
| 20/10/2016 10:27:05 | Swap Deal | 21,922,013.90 | Consortium Trade | - 11,931,000,000 |

The trade screenshot shows how MAST illustrates the critical trading activity within the instance.

1. The trader sold bond future transactions throughout the morning up until the Swap Deal execution time.
2. The Swap Deal was executed at 10.27 am AEST using the prevailing market levels during the pricing window.
3. MAST calculated the impact of each alleged front running trade and assigned a total instance USD value of \$21,922,013.90.

How MAST recognises Primary Market Manipulation

Where pre-hedging of a customer order is not permitted (for example, a related transaction in a primary market deal), MAST analyses the trader's activity prior to the execution of the customer's order. MAST uses its Market Impact Model (MIM) and General Market Model (GMM) to determine and quantify whether the trader's activity is likely to have affected the market and corresponding execution price of the customer order.

Where the trader's activity is expected to have affected the order execution price, MAST will express the gain to the trader as a USD Value. An alert will be generated when the materiality score (USD Value) exceeds a pre-set threshold amount.

MAST's market impact and general market models evaluate cross-product market impact (meaning that the impact of futures trades on swap market prices is covered). Furthermore, evaluation of the market impact on the customer's order considers the timing and size of trades.

Market Abuse Case Studies

Mizuho Primary Market Manipulation

| | |
|--|---|
| Market Abuse Case Study No: 002 | Name: Mizuho Capital Markets LLC |
| Offence: Primary Market Manipulation in Deal Contingent FX Forwards | Detection Control: Front Running V2 (Deal Specific Facilitation) |

 TradingHub

Mizuho Primary Market Manipulation

Market Abuse Case Study No:
002

Name:
Mizuho Capital Markets LLC

Civilian Authority:
Commodity Futures Trading
Commission (CFTC)

Offence:
Primary Market Manipulation in
Deal Contingent FX Forwards

Detection Control:
Front Running V2 (Deal Specific
Facilitation)

Overview

On the 25th of April 2023, the CFTC filed details of proceedings against Mizuho Capital Markets LLC relating to multiple (at least 13) instances of pre-hedging customer trades without disclosure to the customer.

In each case, the customer transactions were deal-contingent FX forward (“DCFX”) transactions, which Mizuho pre-hedged (without disclosure) in the minutes and seconds before quoting (and subsequently trading) the customer trade. The CFTC allege that on these occasions, a Mizuho salesperson advised a Mizuho trader that the client was calling to execute the DCFX forward. The trader then immediately started hedging Mizuho's anticipated exposure. In so doing, the Mizuho trader often traded through multiple price levels before Mizuho provided the spot exchange rate to the client.

Mizuho did not disclose to the client that they engaged in this activity that contributed to moving the spot exchange rate in the relevant currency pair against the client. As such, the client may have entered into the DCFX forward at a less favourable rate. At the same time, Mizuho was able to hedge its exposure at a better rate. These transactions occurred from around June 2018 to at least December 2020.

In response to the proceedings, Mizuho made an Offer of Settlement, which the CFTC has decided to accept.

CFTC's grounds for proceedings

The CFTC considers that Mizuho's activity is in breach of multiple subsections of Section 4s(h) of the Commodity Exchange Act and multiple Commission Regulations.

In particular, the CFTC focuses on the failure of Mizuho to disclose pre-hedging to the customer and considers that this violated the legal and regulatory requirements that swap dealers:

- Disclose material information in a manner reasonably designed to allow a counterparty to assess the material incentives and conflicts of interest that the swap dealer may have (in connection with a particular swap).
- Communicate with any counterparty in a fair and balanced manner based upon principles of fair dealing in good faith.
- Diligently supervise its business as a swap dealer.

Transaction Details & Alleged Harm

The CFTC has decided to accept Mizuho's Offer of Settlement and has not published precise details of Mizuho's trading activity. However, the CFTC has described the nature of the abuse that took place.

In each of the 13 cases, Mizuho's client was involved in a cross-border transaction which typically involved the purchase or sale of a portfolio company. The purchase or sale would involve Mizuho's client paying or receiving a large sum of foreign currency at the close of the transaction. To provide the funds in foreign currency (for a purchase) or repatriate funds received into local currency (for a sale) Mizuho's client required a deal-contingent FX forward.

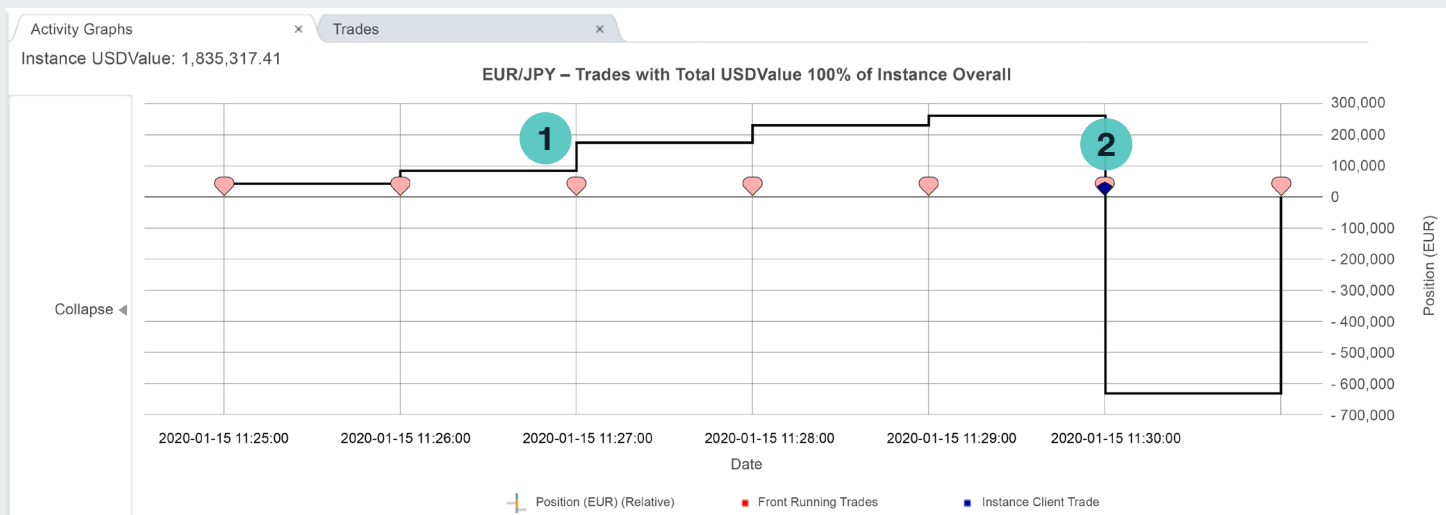
A DCFX transaction is required to hedge against FX market movements for the period up until deal closure whilst protecting against factors resulting in the cancellation such as unsuccessful regulatory approval.

Due to the size and deal-contingent nature of a DCFX transaction, the dealer and client usually agree a pricing methodology to be applied prior to trade execution. This methodology would typically involve a pricing call where the prevailing market FX rate would be observed and a premium is then added to account for the dealer's profit, hedge costs and risk of deal cancellation.

The CFTC alleges that Mizuho pre-hedged (without disclosure and agreement of the client) some or all of the risk related to 13 DCFX cases. This pre-hedging harmed the customer because the act of pre-hedging significant size in the FX market moved the prevailing FX rate against the customer (and made additional profits for Mizuho). Furthermore, the CFTC alleges that such pre-hedging without disclosure breaches the Commodity Exchange Act and Commission Regulations as described in the prior section.

Detecting Primary Market Manipulation in MAST

Whilst the CFTC has not published specific trade details, we have created an example case based on available information and analysed the case in MAST. The graph screenshot shows how MAST illustrates the changing risk position within the instance.



1. The line graph and associated red markers show the trading activity prior to the execution call.
2. The victim trade is highlighted by a blue diamond and shows a corresponding decrease in the EUR position when the deal-contingent FX forward is executed.

| Activity Graphs x Trades x | | | | | |
|---|----------------------|----------------|-------------------|--------------------|--------------------|
| Instance USDValue: 1,835,317.41 | | | | | |
| EUR/JPY - Trades with Total USDValue 100% of Instance Overall | | | | | |
| Collapse | | | | | |
| Date | | | | | |
| Position (EUR) (Relative) | | | | | |
| Front Running Trades | | | | | |
| Instance Client Trade | | | | | |
| Show Relevant Trades Show All Trades | | | | | |
| Trade Date | Client Instrument ID | USDValue | Trade Designation | Amount (Base) | Amount (Quoted) |
| 2020-01-15 11:25:00 | Buy EUR, Sell JPY | 387,654.76 | Front Running | 100,000,000.00 | -11,806,237,645.51 |
| 2020-01-15 11:26:00 | Buy EUR Sell JPY | 377,742.02 | Front Running | 100,000,000.00 | -11,806,237,645.51 |
| 1 2020-01-15 11:27:00 | Buy EUR, Sell JPY | 366,494.49 | Front Running | 100,000,000.00 | -11,806,237,645.51 |
| 2020-01-15 11:28:00 | Buy EUR, Sell JPY | 356,147.88 | Front Running | 100,000,000.00 | -11,806,237,645.51 |
| 2020-01-15 11:29:00 | Buy EUR, Sell JPY | 347,278.26 | Front Running | 100,000,000.00 | -11,806,237,645.51 |
| 2 2020-01-15 11:30:00 | Sell EUR, Buy JPY | 1,835,317.41 3 | Instance Client | - 2,000,000,000.00 | 236,124,752,910.17 |

The trade screenshot shows how MAST illustrates the key trading activity within the instance.

1. The front-running trades show trading in the minutes running up to the deal-contingent FX forward. The fact that Mizuho was engaging in this trading activity was not disclosed to the customer.
2. The deal-contingent FX forward spot rate is agreed in an execution call based on the prevailing FX rate.
3. MAST calculated the harm from the market impact of the front running trades on the deal-contingent FX forward and assigned a USDValue of \$1,835,317.41.

How MAST recognises Primary Market Manipulation

Where pre-hedging of a customer order is not permitted (for example, a related transaction in a primary market deal), MAST analyses the trader's activity prior to the execution of the customer's order. MAST uses its Market Impact Model (MIM) and General Market Model (GMM) to determine and quantify whether the trader's activity is likely to have affected the market and corresponding execution price of the customer order.

Where the trader's activity is expected to have affected the order execution price, MAST will express the gain to the trader as a USD Value. An alert will be generated when the materiality score (USD Value) exceeds a pre-set threshold amount.

MAST's market impact and general market models evaluate cross-product market impact (meaning that the impact of futures trades on swap market prices is covered). Furthermore, evaluation of the market impact on the customer's order considers the timing and size of trades.

Market Abuse Case Studies

HSBC Primary Market Manipulation

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|---|---|
| Market Abuse Case Study No: 003 | Name: HSBC Bank USA, N.A. |
| Alleged Offence: Primary Market Manipulation in Issuer Swaps | Detection Control: Front Running V2 (Deal Specific Facilitation) |

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HSBC Primary Market Manipulation

Market Abuse Case Study No:
003

Name:
HSBC Bank USA, N.A.

Civilian Authority:
Commodity Futures Trading
Commission (CFTC)

Alleged Offence:
Primary Market Manipulation in
Issuer Swaps

Detection Control:
Front Running V2 (Deal Specific
Facilitation)

Overview

On the 12th of May 2023, the CFTC filed details of proceedings against HSBC Bank USA, N.A., which alleges that HSBC engaged in or attempted to engage in multiple cases of market manipulation and deceptive trading practices between March 2012 and 2015.

In each case, the alleged misconduct relates to activity in primary markets, particularly interest rate swaps that HSBC traded with bond issuers.

In response to the proceedings, HSBC made an Offer of Settlement, which the CFTC accepted.

CFTC Grounds for Proceedings

In each case, a bond issuer executed a large interest rate swap with HSBC as a hedge against interest rate movements (an “issuer swap”) (thereby swapping fixed interest bond coupon payments into floating rate payments to HSBC). The CFTC asserts that, in each case, HSBC traded in advance of the issuer swap to intentionally move the market price and thereby execute the issuer swap at a more favourable level to HSBC.

The CFTC considers this activity to be a form of market manipulation and is in breach of multiple sections of both the Commodity Exchange Act and Commission Regulations.

Transaction Details and Alleged Harm

The CFTC accepted HSBC’s Offer of Settlement and has therefore not published precise details of HSBC’s trading activity. However, the CFTC has described the pattern of transactions and alleged harm to the customer that occurred.

The pricing of an issuer swap typically involves a pricing call where traders from the bank providing the issuer swap will quote the current prices of the relevant financial instruments. The prices quoted during the pricing call are then used to determine prices for the bond and the issuer swap.

For a U.S. dollar bond issue and related interest rate swap, the relevant prices include:

- U.S. Treasuries (the yield of an equivalent maturity bond).
- Swap Spreads (differential of the swap rate vs. U.S. Treasury yield of equivalent maturity).
- Basis Swaps (the rate payable on a swap translating Libor of one tenor for another).

The source of the live prices used are pre-agreed and are usually quoted from screens published by broker firms. These screens display prices from the relevant broker firm, and trades executed through the relevant broker firm can affect the prices displayed on the screen.

The CFTC alleges that when HSBC traders sought to manipulate the profitability of issuer swaps, their activity would follow a distinct pattern. First, HSBC’s traders would listen in on the pricing call to gauge exactly when HSBC would be quoting the prices of the relevant products. Next, shortly before the crucial moment at which HSBC would be asked to quote the price of the relevant financial product, the traders who were listening into the pricing call would trade with the relevant broker. Their

focus would be on moving the screen price ahead of the moment that HSBC quoted the price to the customer.

The CFTC goes on to describe high-level details of individual cases. In one case, they describe a trader who asked the broker to “sell a billion” and “hit ‘em all down” just before he was asked to quote the price of the relevant instrument on the pricing call. The CFTC did not provide details of the relevant instrument where the abuse occurred, but as described previously, relevant instruments include U.S. Treasuries, Swap Spreads and Basis Swaps.

Detecting Primary Market Manipulation in MAST

Whilst the CFTC has yet to publish full trade details, we have created an example case based on information known, and analysed the case in MAST. In this circumstance, 5-year U.S. Treasuries are used to manipulate the price of a \$2bn issuer swap with slightly longer maturity. The graph screenshot shows how MAST illustrates the changing risk position within the instance.



This scenario has been calculated and run through MAST. The graph screenshot shows how MAST illustrates the changing risk position within the instance.

1. The line graph and associated red markers for the trades show the trading activity prior to the execution of the issuer swap.
2. The victim trade is highlighted by a blue diamond when the issuer swap is executed at 15:00:00.

| Show Relevant Trades <input checked="" type="checkbox"/> Show All Trades | | | | | |
|--|------------------------|--------------|-------------------|-------------------|--|
| Trade Date | Client Instrument ID | USDValue | Trade Designation | Amount | |
| 2023-07-11 15:00:00.000 | 5yr USD DC Swap | 1,186,512.78 | Instance Client | -2,500,000,000.00 | |
| 2023-07-11 14:59:16.158 | BOND US91282CHK09 ... | 234,234.34 | Front Running | 250,000,000.00 | |
| 2023-07-11 14:58:16.522 | BOND US91282CHK09 ... | 195,503.16 | Front Running | 150,000,000.00 | |
| 2023-07-11 14:58:00.000 | BOND US91282CHK09 ... | 152,302.00 | Front Running | 100,000,000.00 | |
| 2023-07-11 14:58:32.103 | BOND US91282CHK09 ... | 147,050.53 | Front Running | 125,000,000.00 | |
| 2023-07-11 14:58:10.234 | BOND US91282CHK09 ... | 106,846.00 | Front Running | 75,000,000.00 | |
| 2023-07-11 14:58:58.254 | BOND US91282CHK09 ... | 103,838.25 | Front Running | 100,000,000.00 | |
| 2023-07-11 14:59:24.670 | BOND US91282CHK09 ... | 84,264.11 | Front Running | 100,000,000.00 | |
| 2023-07-11 14:59:37.236 | BOND US91282CHK09 ... | 80,130.56 | Front Running | 100,000,000.00 | |
| 2023-07-11 14:58:44.469 | BOND US91282CHK09 ... | 54,435.98 | Front Running | 50,000,000.00 | |
| 2023-07-11 14:58:41.604 | BOND US91282CHK09 ... | 27,907.86 | Front Running | 25,000,000.00 | |

The trade screenshot shows how MAST illustrates the key trading activity within the instance.

1. Pre-hedging occurred via the purchase of US Treasuries.
2. The issuer swap was executed at 15:00:00.
3. MAST calculated the harm from the market impact of the pre-hedging on the issuer swap and assigned a materiality score of \$1,186,512.78.

How MAST Recognises Primary Market Manipulation

Where pre-hedging of a customer order is not permitted (for example, a related transaction in a primary market deal), MAST analyses the trader's activity prior to the execution of the customer's order. MAST uses its Market Impact Model (MIM) and General Market Model (GMM) to determine and quantify whether the trader's activity is likely to have affected the market and corresponding execution price of the customer order.

Where the trader's activity is expected to have affected the order execution price, MAST will express the gain to the trader as a USD Value. An alert will be generated when the materiality score (USD Value) exceeds a pre-set threshold amount.

MAST's market impact and general market models evaluate cross-product market impact (meaning that the impact of futures trades on swap market prices is covered). Furthermore, the evaluation of the market impact on the customer's order considers the timing and size of trades.

Market Abuse Case Studies

John Gorman III - Primary Market Manipulation

| | |
|--|---|
| Market Abuse Case Study No: 004 | Name: John Gorman III |
| Alleged Offence: Primary Market Manipulation in Bond Issuer Swaps | Detection Control: Front Running V2 (Deal Specific Facilitation) |

 TradingHub

John Gorman III - Primary Market Manipulation

Market Abuse Case Study No:
004

Name:
John Gorman III

Civilian Authority:
Commodity Futures Trading
Commission (CFTC)

Alleged Offence:
Primary Market Manipulation in
Bond Issuer Swaps

Detection Control:
Front Running V2 (Deal Specific
Facilitation)

Overview

On the 1st February 2021, the CFTC filed a complaint at the U.S. District Court (Southern District of New York) against John Gorman III, a U.S. dollar swaps trader for Nomura based in Tokyo. The complaint alleges that Gorman engaged in a scheme to deceive and manipulate the price of U.S. dollar interest rate swap spreads to benefit Nomura in an interest rate swap transaction associated with a bond issue (an "issuer swap") that was being priced at the time by Nomura (his employer).

The alleged market abuse occurred shortly after midnight in Tokyo on the 4th February 2015, corresponding to the morning of the 3rd February in New York. On this date, a 10-year \$1bn bond issuance was being priced together with a related interest rate swap that the bond issuer had agreed to transact with Nomura.

The pricing methodology/formula for the interest rate swap had already been agreed and would be based upon the prevailing price of 10-year U.S. dollar swap spreads. Furthermore, a particular pricing screen (the "19901" screen) of a Swap Execution Facility ("SEF") was to be used to reference the prevailing 10-year swap spreads price. This screen showed live prices, and it was agreed that during a pricing call (where the swap rate would be set), Gorman would communicate the live swaps spread price from this screen. The CFTC alleges that Gorman manipulated this price (the 10-year swaps spread) on the 19901 screen via multiple swap spreads transactions in the minutes and hours prior to the call.

Transaction Details and Related Comms

The CFTC's allegations are based upon Gorman's pattern of transactions and orders prior to the pricing call and his related communications.

In particular, the CFTC alleges that Gorman made the following trades prior to the swap price fixing, which occurred about 20 seconds after the trade at 1:24 am JST in a pricing call:

- 12:45 am JST: Gorman sold @ 13.25
- 1:13 am JST: Gorman sold @ 13.5
- 1:16 am JST: Gorman sold twice @ 13.5
- 1:20 am JST: Gorman sold @ 13.75
- 1:24 am JST: Gorman sold at 13.5

In each case, the transaction was a 10-year swap spreads trade executed on the same SEF as referenced in the pricing formula (allegedly to achieve the maximum level of price manipulation for the issuer swap fixing). The court filing also indicates sizes of \$50m for each individual transaction (where specified). Assuming this size is

roughly applicable to each transaction, this would imply Gorman sold about \$300m in 10-year swap spreads prior to the price-fixing of the issuer swap.

In relation to Gorman's communications, the CFTC asserts that these show the clear intent of Gorman to manipulate the issuer swap price fixing. The CFTC highlights various communications, including the following:

- At 12:51 am JST, Gorman told the head of the swaps desk in New York that he thought he could move the screen down to 13.25 ("I will get the print at 13.25").
- At 12:53 am JST, the swaps desk head told Gorman not to "waste too many bullets" – this is not to sell too much – trying to get the price to 13:25 and that there was a "solid bid for spreads".
- In response at 1:07 am, JST Gorman said, referring to the upward movement of the market, which was unfavourable to the bank, "I hate pricing these when momentum is against us. Takes all the fun out of it".

The Alleged Harm

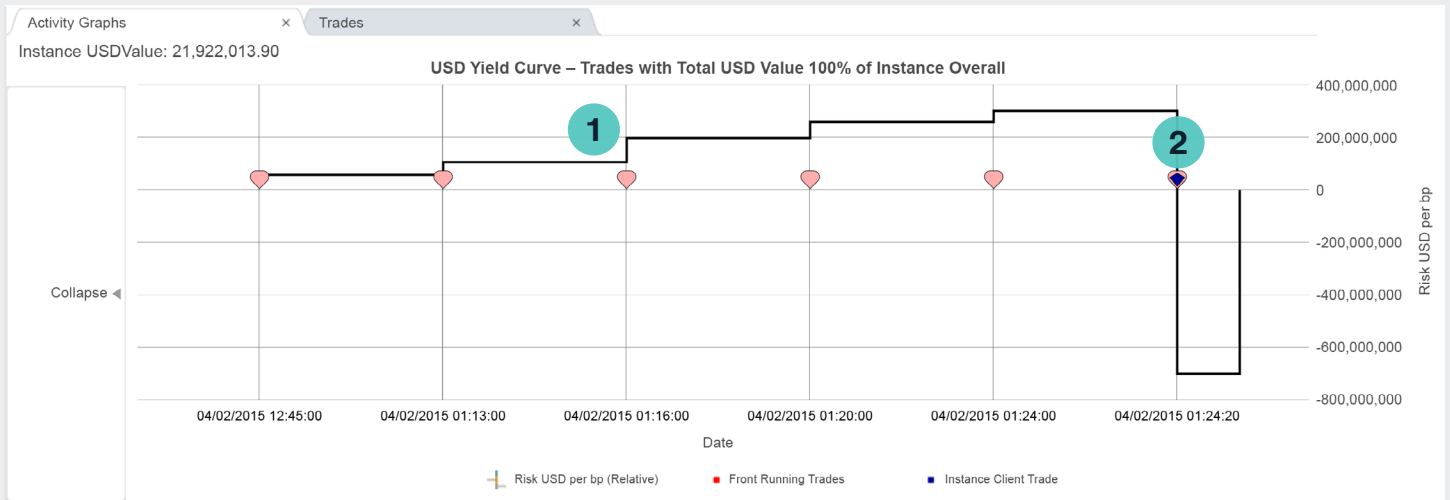
During the alleged market manipulation period, the CFTC describes how the market in 10-year swap spreads moved higher (from 13bps to 13.75bp), with the issuer swap price fixing occurring when the market was at 13.5bps. The increase in the market price happened despite the c. \$300m of 10-year swap spreads that Gorman sold (due to the significant amount of buying interest at the time from the rest of the market).

It is, therefore, unclear if Gorman's was successful in moving the price in Nomura's favour and to what extent. One estimate is that he managed to move the market 0.25bps lower (as the market was 13.75 right before his final trade, and the price fixing occurred immediately after using a 13.5bps reference price).

As the 10-year issuer swap would have had a DV01 slightly below \$1m per bp, every 0.25bps of price manipulation would have benefited Nomura by approximately \$250k in P&L at the detriment of the issuer.

However, the CFTC's case relies not on whether Gorman was successful but rather on his intent. They assert that he is guilty of market manipulation because his trading activity and communications show a clear intent to commit market manipulation.

Detecting Primary Market Manipulation in MAST



This scenario has been mocked up and run through MAST. The graph screenshot shows how MAST illustrates the changing risk position within the instance.

1. The line graph and associated red markers show the build-up of the interest rate risk position trading activity prior to the pricing call.
2. The victim trade is highlighted by a blue diamond and shows a corresponding fall in the interest rate risk position when the issuer swap is executed at 01:24:20 JST.

| Activity Graphs | | Trades | | |
|-----------------------|----------------------|--|-------------------|----------------|
| | | Show Relevant Trades <input checked="" type="checkbox"/> Show All Trades | | |
| Trade Date | Client Instrument ID | USDValue | Trade Designation | Amount |
| 04/02/2015 12:45:00 | USD 10Y Swap | 5,944.70 | Front Running | 50,000,000 |
| 04/02/2015 01:13:00 | USD 10Y Swap | 32,342.18 | Front Running | 50,000,000 |
| 1 04/02/2015 01:16:00 | USD 10Y Swap | 107,773.84 | Front Running | 100,000,000 |
| 04/02/2015 01:20:00 | USD 10Y Swap | 54,571.55 | Front Running | 50,000,000 |
| 04/02/2015 01:24:00 | USD 10Y Swap | 57,174.70 | Front Running | 50,000,000 |
| 2 04/02/2015 01:24:20 | Issuer Swap | 257,806.97 3 | Instance Client | -1,000,000,000 |

The trade screenshot shows how MAST illustrates the key trading activity within the instance.

1. The trader executed five trades prior to the swap price fixing which exerted downward pressure on the rate used for the swap price fixing.
2. The swap price fixing occurs at 01:24.20 JST using the price visible on the live screen.
3. MAST calculated the harm from the market impact of the front running trades on the issuer swap and assigned a USDValue of \$257,806.97.

How MAST recognises Primary Market Manipulation

Where pre-hedging of a customer order is not permitted (for example, a related transaction in a primary market deal), MAST analyses the trader's activity prior to the execution of the customer's order. MAST uses its Market Impact Model (MIM) and General Market Model (GMM) to determine and quantify whether the trader's activity is likely to have affected the market and corresponding execution price of the customer order.

Where the trader's activity is expected to have affected the order execution price, MAST will express the gain to the trader as a USD Value. An alert will be generated when the materiality score (USD Value) exceeds a pre-set threshold amount.

MAST's MIM & GMM models evaluate cross-product market impact (meaning that the impact of futures trades on swap market prices is covered). Furthermore, evaluation of the market impact on the customer's order considers the timing and size of trades.

Advance your surveillance function

Detect cross-product abuse,
reduce false positives, and
prioritise high-risk alerts.

Reach out to learn more.



tradinghub.com/MAST



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