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)

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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.

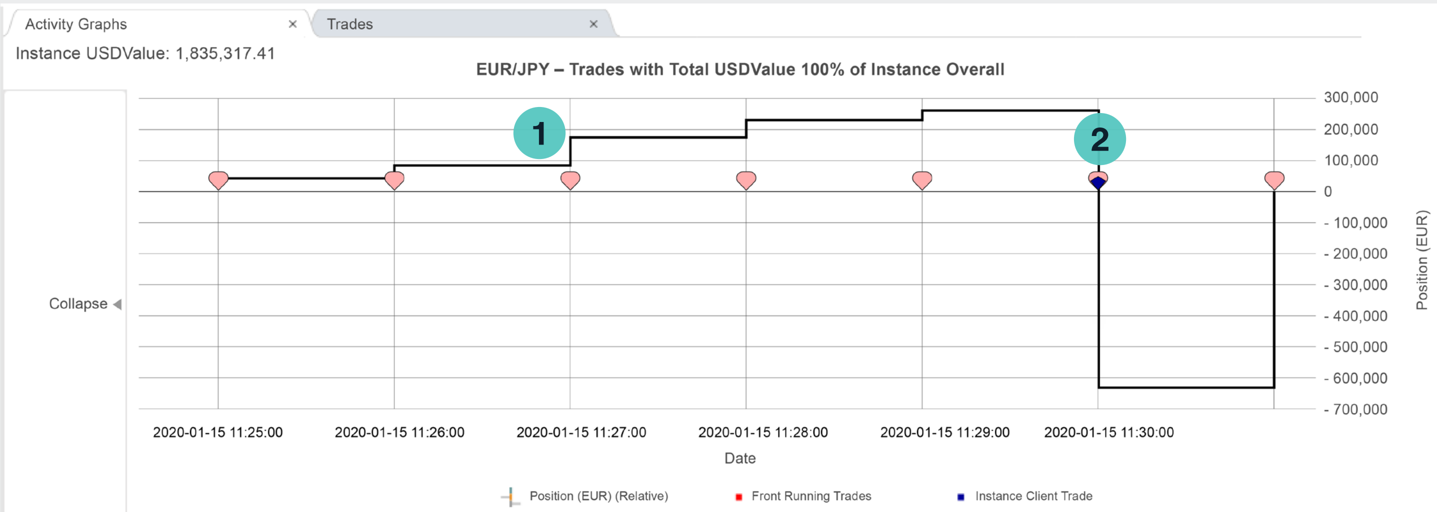
A DCFX transaction is required to hedge against FX market movements for the period up until deal closure whilst protecting against factors resulting in the cancellation such as unsuccessful regulatory approval.

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 × Trades ×

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.

Advance your surveillance function

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

Reach out to learn more.

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