United States v. Johnson: Implications for the Industry

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"*Former HSBC Executive Convicted of Fraud for Front-Running: Mark Johnson Found Guilty on Nine Counts Related to a $3.5 Billion Currency Trade*" – Wall Street Journal, October 23, 2017

- The DOJ charged Mark Johnson (HSBC's global head of FX trading) and Stuart Scott (HSBC's European head of FX trading) with wire fraud, for front-running its counterparty Cairn Energy in a $3.5 billion cable fixing order
- HSBC and Cairn entered into an NDA and, subsequently, a "Mandate Letter," which set forth the terms of HSBC's engagement
- The Mandate Letter provided that the transaction would be governed by an ISDA agreement, which in turn provided that HSBC and Cairn were transacting on a principal-to-principal basis
- The government contended, and the trial court agreed, that a fiduciary relationship could exist between HSBC and Cairn based on "best execution"-like assurances that Johnson and Scott made to Cairn during the RFP process
- On October 23, 2017, Johnson was convicted on eight wire fraud counts and one conspiracy count, and acquitted of one wire fraud caught. Johnson was sentenced to 24 months imprisonment. Johnson has appealed his conviction.

Did HSBC Act as a Principal or as a Fiduciary – The DOJ's Case

- HSBC executed an NDA with Cairn during the RFP process, promising that it would not use its knowledge of Cairn's position for any purpose other than executing Cairn's trade
- Johnson and Scott also assured Cairn that it would "drip feed" its purchase of Sterling to avoid spiking the fixing price
- More broadly, HSBC's RFP response said that HSBC would execute the trade in the "best interest" of Cairn
- In connection with the NDA, HSBC walled off the traders executing the Cairn trade from others at HSBC. Despite this wall, Johnson allegedly instructed those on the other side of the wall to trade ahead of the fix
- Conduct by Johnson during and after the trade also suggests a guilty conscience
  - Johnson instructed traders to buy Sterling in large volume just before the fixing by using coded language ("My watch is off")
  - Johnson then told Scott on a subsequent phone call: "I think we got away with it."

Did HSBC Act as a Principal or as a Fiduciary – Johnson's Case

- Cairn hired Rothschild & Co. to act as its financial advisor in the transaction, and Johnson disclosed to Rothschild during the RFP process that HSBC would try to profit by purchasing Sterling ahead of the fix
- After it won Cairn's business and after making the assurances that the DOJ relied upon, HSBC and Cairn executed a Mandate Letter, in which Cairn acknowledged that HSBC's purchase of Sterling prior to the fix might cause adverse price movement
- The Mandate letter incorporated by reference an ISDA agreement that made clear that HSBC was dealing with Cairn as a principal and was not acting in an advisory or fiduciary capacity
- Cairn also conceded, after the trade, that it had expected HSBC would try to make a "fair profit" by "beating the fix."

Implications: Should Courts Disregard Contractual Waivers of Fiduciary Duty?

- Johnson made several statements to Cairn regarding when and how HSBC would execute, in order to assure Cairn that HSBC would attempt to maximize value for Cairn
- After receiving these specific assurances, Cairn executed a Mandate Letter and an ISDA agreement, acknowledging a risk that HSBC's purchase of Sterling would move the market against Cairn, and agreeing that HSBC was not acting in a fiduciary capacity
- Read narrowly, this implies that very specific assurances cannot be negated by subsequent, general disclosures
- More controversially, it invites courts to scrutinize the conduct of a trade in order to decide whether to honor the terms of an ISDA agreement. But standardized agreements such as ISDAs exist, in part, to minimize the risk of these sorts of fact-specific examinations

Implications: Constraints on Arms-Length Dealing

Recent legal, regulatory and industry guidance all suggest that dealers may need to observe a “fairness” requirement even when trading as a principal

- Johnson’s conviction and the ongoing Bogucki case both premise fraud convictions on assurances made in the context of an arms-length relationship
- CFTC has suggested a “fair-dealing” standard should apply to communications from swap dealers / major swap participants
- NYDFS settlements have imposed what amounts to a “fair dealing” requirement on FX dealers
- The FX Global Code refers to counterparties as “clients,” places strict limits on dealers’ permissible pre-hedging, and requires fairness in pricing, among other things

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