American Bar Association, Litigation Section
Securities Litigation Committee

ARTICLES

The Evolving Line Between Legal and Illegal Trading and Sales Practices in the Market Intermediary and Customer Relationship

Legal and market considerations for broker-dealers and customers.

By Pat Linehan, Wesley Heath, Jennifer Shulkin – August 4, 2021

The federal government has recently brought a number of criminal cases concerning the relationship of broker-dealers serving as market intermediaries with their customers in sophisticated markets where trading is largely over the counter and historically lightly regulated. These prosecutions have sought to charge securities fraud or wire fraud or both. This push is distinct from cases involving allegations of collusion in lending rate, foreign exchange, and commodities markets under antitrust law. The trend is also distinct from recent and older cases involving market manipulation through fraudulent devices and from recent spoofing cases.

Courts have grappled with whether the relationship between a market intermediary and its customer is more akin to arm's-length bargaining or a more fiduciary-type duty. Courts' analyses of that relationship pose two interrelated questions for intermediaries. First, should placing trades prior to the execution of the counterparty transaction be characterized as impermissible frontrunning of the customer or permissible bona fide hedges (also known as pre-positioning or pre-hedging)? Second, when do aggressive sales tactics result in the intermediary undertaking additional obligations to its customer? Unsurprisingly, the answers are far from clear, yet they will have substantial commercial implications on how intermediaries price transactions and manage their inventories. Some potential legal risk mitigation strategies for intermediaries are also beginning to emerge from these prosecutions.

Pre-positioning describes when an intermediary engages in transactions before a potential customer order for the purposes of acquiring inventory to fulfill the order, managing price risk by taking a hedge position, or earning a profit from expected demand. Frontrunning, on the other hand, has been described as when the intermediary enriches itself by taking improper advantage of its knowledge of the timing of the customer's upcoming transaction. As discussed below, the distinction between what an intermediary views as pre-positioning and what prosecutors have branded as frontrunning turns in part on whether the intermediary and customer are in an arm's-length or principal-agent relationship. In both relationships, the courts have sought to determine whether a reasonable investor would rely on any alleged misstatements by the intermediary as to pre-positioning or other terms—i.e., whether the misstatement was "material." Any alleged misstatements in a principal-agent relationship are more likely to be material than in an arm's-length one and thus cross the line into criminality.

In these recent prosecutions, the government has attempted to blur the line between frontrunning and pre-positioning. Some judges have seen the prosecutions as attempting to criminalize long-standing industry practices, while others have approved the government's main prosecutorial approaches as applied to the specific facts.

The problems of the nature of the intermediary-counterparty relationship and aggressive sales tactics potentially resulting in additional customer obligations have also arisen in the context of statements made about the pricing of a transaction. In both the pricing and pre-positioning/frontrunning context, the government has employed two theories of fraud that both originate from the requirement that misstatements in a transaction are fraudulent only if material to a reasonable investor. As discussed below, materiality hinges on either the specific nature of the parties' relationship or other circumstances surrounding the transaction.

Prosecution Approach No. 1: Misstatements Occurring in a Fiduciary-Like Relationship
Under this approach, the government invokes the basic concept that misstatements assume greater importance when an agency-like relationship exists and thus may more easily cross the line into materiality and criminality. When failing to convince courts that an express agency relationship exists, the government has tried to argue that a similar relationship of trust and confidence exists outside of a formal agency relationship. This charging theory has met limited success.

A prime example of the limited success of this theory is *United States v. Bogucki*, a case involving Barclays's head of foreign exchange trading being charged with wire fraud for trading ahead of a customer's transaction. The government conceded that no fiduciary relationship existed but still sought to use testimony on a relationship of trust and confidence as part of the materiality test. The court disagreed, describing the intermediary and counterparty as "arms-length principals engaged in interactions for their own mutual benefit" and rejecting the argument that sharing confidential information in and of itself created a duty of trust and confidence. The court relied heavily on the parties having executed an International Swaps and Derivatives Association (ISDA) agreement that expressly stated that each party acted as principal and not fiduciary or agent for the other.

In contrast, a "fiduciary-like relationship" was found in *United States v. Johnson*, a case also concerning foreign exchange transactions, between HSBC acting as an intermediary bank and a customer, largely because of the existence of a nondisclosure agreement and request for proposal between the parties. Comparing *Johnson*, in which the trader was convicted by a jury following the district court's acceptance of the government's fiduciary theory as viable, with *Bogucki* illustrates that the paperwork and details of the contracts are critical to finding an agency-like relationship. *Bogucki* distinguished that relationship from the one in *Johnson* on the basis that there was neither a nondisclosure agreement nor a request for proposal signifying a heightened duty to the customer.

Another example is *United States v. Litvak*. Not a frontrunning case, *Litvak* instead concerned a senior trader in the residential mortgage-backed securities (RMBS) market charged with securities fraud for allegedly misrepresenting the prices at which he could buy or sell securities and consequently inducing buyers to overpay for the RMBS. In 2018, the Second Circuit vacated his conviction following a second trial on evidentiary grounds, holding that a counterparty's incorrect subjective trust placed in the intermediary was irrelevant to whether misstatements were material. Although holding that the intermediary's misstatements were not immaterial as a matter of law, it determined that the trial court improperly admitted testimony that the customer erroneously believed Litvak was the customer's agent.

United States v. Gramins—another case about an RMBS trader who lied to counterparties about contemporaneous price negotiations with other counterparties, causing them to increase their bids and decrease their offers—is similar to *Litvak* but resulted in a different outcome. The trader in *Gramins* misled his customers by representing that he would earn "a modest commission to facilitate supposedly 'riskless' transactions with those counterparties [while] [i]n reality . . . reap[ing] substantial profits unbeknownst to the counterparty on either side of the transaction." Rejecting the district court's decision to grant Gramins a new trial based on *Litvak*, the Second Circuit reinstated his conviction because it determined that the counterparty witness had actually made no *explicit* misstatements of agency principles. In other words, without a counterparty's (or the government's) express mention of erroneous agency beliefs, the conviction was upheld.

Interestingly, in both *Bogucki* and *Litvak*, the intermediaries' assumption of the market risk if the counterparties decided not to execute the planned transaction was significant to finding that a principal-agent relationship did not exist. In purchasing inventory in the market, the intermediaries assumed the risk that the customer would not ultimately execute, making those purchases more akin to pre-positioning hedges than to frontrunning any future order. Similarly, although a code of conduct for foreign exchange intermediaries rather than a legal rule, the FX Global Code in Principle 11 considers the firmness of a customer's order, among other factors, in determining whether pre-positioning is a proper practice. Generally speaking, the cases to date suggest that the less firm an order, the more unlikely that a court will find a principal-agent relationship. Although the government's theory of a fiduciary-like relationship between intermediaries and counterparties has been met with limited success to date, the myriad of factual situations that can arise may produce scenarios where courts are more receptive.

Prosecution Approach No. 2: Materiality Based on Specific Representations That Impact the Transaction

The government has also asserted a second more conventional theory in these prosecutions—simply that the intermediary acting in a nonfiduciary capacity made a material misstatement during the transaction. Although these fraud principles are well trod, their application to these sophisticated transactions raises the intriguing problem of when do misstatements result in the intermediary taking on obligations to its customer that normally would not exist in a typical arm's-length relationship? If aggressive sales tactics are later found to have included a material misstatement, the intermediary may have bound itself to a very different transaction, including limiting the manner of execution or inventory acquisition and ultimately assuming more market risk than intended.

Under this theory, the government has essentially argued that an intermediary's misstatement constitutes fraud when capable of influencing the counterparty's decision to "part with its money or property" and engage in a transaction that it otherwise would not have. Whether a misstatement supports a fraud conviction depends on whether there is a substantial likelihood that a reasonable investor would find the misrepresentation important in making an investment decision. This is an objective, rather than a subjective, standard. And in sophisticated markets, it is a high bar, as *Bogucki* makes clear.

Litvak makes the point that the objective reasonable investor standard may vary depending on the nature of the traders in the particular market, such as whether it is an institutional or an individual investors market. Just as it did with the government's fiduciary theory, the wording of the agreement between the parties sets the background for the type of relationship formed. For instance, an agreement could restrict the types of transactions an intermediary could make (e.g., requiring a certain kind of execution or forbidding pre-positioning) or require full disclosure of the intermediary's position.

Market practice, which varies significantly by product, is also significant to determining materiality. If some bluffing, puffery, or even misleading people about positions is normal, such behavior is likely not material. In *Bogucki*, for example, the court found that five alleged lies were not material, including the intermediary's misrepresentation of its position by stating that it would not "touch[] the market," conditionally promising what it would do if the counterparty decided not to use its services, communicating the benefits of confidentiality and excluding multiple dealers, and recommending a quiet execution. Crucial to the court's holding that these would not be material to a reasonable investor were concessions by the government and its witnesses that pre-positioning was common market practice, that the counterparty—who was experienced in the foreign exchange market—also lied and bluffed to the intermediary, and that the counterparty even expected the intermediary to be dishonest at times.

On the other hand, the Second Circuit in *Johnson* affirmed the conviction of the intermediary's trader based on a misrepresentation that he would "quietly" execute any pre-positioning and not "ramp the fix" between the U.S. dollar and British pound. The "fix" occurred hourly and set the transaction's price. The court found that the jury reasonably concluded that Johnson materially misrepresented the execution method he would use to avoid increasing the price. *Johnson* demonstrates not only that the content of agreements matters but that oral conversations may also restrict the manner in which the intermediary can trade during pre-positioning. As the Second Circuit emphasized, the intermediary's disclosure of its intention to trade ahead of the fix was not a defense when it misrepresented how it would trade. Although the Second Circuit found it unnecessary to consider whether a fiduciary relationship created a lower standard of materiality, the end result was largely the same because the intermediary had effectively assumed a number of additional obligations, resulting in fraud when it failed to follow them.

The government has also emphasized a misstatement's impact on pricing in arguing materiality. In *Gramins*, the Second Circuit upheld a conviction of an RMBS trader who was found to have misrepresented price negotiations with other counterparties and to have misled both the counterparties selling to and buying from him on the spread the intermediary would earn. As in *Johnson*, the misrepresentation's impact on the price the customer paid was significant to finding materiality. Reconciling *Gramins* and *Bogucki* is more difficult, but the Second Circuit seems to have considered the specific misstatements in *Gramins* regarding the pricing of inventory and the spread earned to be more egregious than the type of puffery the district court considered in *Bogucki*. Unlike *Bogucki*, *Gramins* also appeared to lack evidence that making inaccurate statements regarding pricing and spreads was common and understood market practice. Materiality is highly fact-specific and caution is warranted—particularly regarding misleading oral statements that may influence the price a customer is willing to pay.

Looking Forward

Despite the setbacks in *Bogucki* and *Litvak*, the government in July 2021 indicted Sean Wygovsky, a trader at an asset management firm, for misappropriating confidential, nonpublic information to profit personally by frontrunning large trades he was executing for clients on behalf of his employer. At the moment, the legal theory in *United States v. Wygovsky* appears more akin to insider trading involving the misappropriation of material nonpublic information from an employer rather than fraud on a counterparty through material misstatements. Notably, though, the Securities and Exchange Commission filed a simultaneous civil action that alleges fiduciary duty violations both to the employer and to its clients, potentially implicating the fiduciary duty theory of frontrunning. The impact of this prosecution on the issues discussed will depend on how the government develops its case, but the decision to bring the case suggests that its heightened scrutiny of potential frontrunning will continue.

The recent criminal prosecutions demonstrate that market practice and the actual agreements between the intermediaries and counterparties govern their relationship and, by extension, what conduct crosses the line into illegality. Market intermediaries should be careful not to make misleading statements regarding significant terms and should put in place policies that govern trader conduct in this area. Enhanced training about what sales tactics run the risk of a disappointed counterparty contacting criminal authorities is an essential risk mitigator. Close attention to counterparty agreements, particularly ones other than more standardized ISDAs, is essential, as are clear communications with traders to make sure they understand when those documents and oral representations may limit their ability to conduct business as usual.

Because oral statements by traders may modify the typical arm's-length relationship, intermediaries should not simply rely on ISDAs to document the expected relationship. Affirmative disclosures can provide a strong additional layer of protection by addressing the nature of the arm's-length relationship with the customer and providing examples of the types of market activity in which the intermediary may engage. Ideally, these disclosures should be made product-specific by incorporating relevant market practice. Given the stakes, extensive review by both internal and external counsel, along with regular updates, is also advisable.

The commercial implications for intermediaries and even customers in departing from an arm's-length relationship are substantial. If an intermediary enters into a relationship with a customer that is not at arm's length, it needs to alter its pricing to reflect any additional market risk. Beyond affecting the pricing of transactions, a shift in the nature of the relationship between intermediaries and customers raises inventory management issues. Inventories held by intermediaries are already substantially smaller than before the financial crisis, reducing the liquidity they can provide. Particularly large transactions, even in highly liquid markets like foreign exchange, may become more cumbersome if courts determine that acquiring inventory to fulfill a potential customer order constitutes frontrunning. Such a rule would likely push intermediaries toward executing transactions during more liquid periods—an outcome that could increase price volatility and raise allegations of manipulation.

In addition, a legal line that weighs more heavily an order's firmness in determining whether pre-positioning is permissible could provide somewhat clearer legal guidance and allow intermediaries smoother pricing and inventory management. However, any such rule would still leave substantial ambiguity for nonstandard orders that have elements of firmness but are not completely firm. Such a line would also leave unaddressed the *Johnson* and *Gramins* situations where the misrepresentations concerned, respectively, the manner in which pre-positioning could take place and the prices the trader was seeing from other counterparties.

Whether a misstatement made during these sophisticated transactions is material will remain highly fact-specific, but courts have exhibited more willingness to find a misstatement material when it had a clear impact on price. Court decisions going forward may even shift the standard of behavior a reasonable investor expects, potentially moving the line separating legality and illegality along with them.

Until clearer lines emerge, enhanced training for an intermediary's traders, careful legal review of the documents establishing the terms of the relationship between the intermediary and customer, and affirmative disclosures to customers are the best hedges against unwelcome scrutiny by criminal prosecutors.

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