



Foreign Exchange Trading: Secret Profits and Hidden Losses

By: Darren J. Check, Esq., Naumon A. Amjed, Esq. and Ryan T. Degnan, Esq.

Custodial banks' foreign exchange ("FX") trading practices have recently drawn scrutiny from state attorneys general, public and private pension funds, and the financial media for manipulating FX rates charged to the banks' clients. In short, custodial banks offer FX trading services to allow their clients to convert currencies in order to buy and sell foreign securities and to engage in other transactions. As detailed below, however, custodial banks have come under fire for secretly charging their clients less favorable FX rates than those actually incurred by the bank when the FX trade is executed. Details about the banks' practices have come from lawsuits, including several whistleblower (or *qui tam*) actions filed on behalf of state funds in California, Virginia and Florida.¹ The actions generally allege that custodial banks execute trades at one rate but charge clients a different (less favorable) rate based on post-trade movements in FX prices. By manipulating FX rates without their clients' knowledge, custodial banks generated hundreds of millions of dollars in secret profits at the expense of the banks' clients. FX trading is big business and large custodial banks such as State Street Corporation ("State Street"), The Bank of New York Mellon Corporation ("BNY Mellon"), and Northern Trust Corporation ("Northern Trust") earn approximately 7%-12% of their annual revenue from FX trading.²

To date, three *qui tam* actions alleging improper FX trading practices at custodial banks have been unsealed. Additionally, two class actions, including one filed by Kessler Topaz, have been filed against custodial banks by pension and retirement funds. The Securities and Exchange Commission ("SEC") is also investigating BNY Mellon's FX related disclosures to its custodial clients.³ We briefly discuss these actions below.

¹ A *qui tam* action is a lawsuit brought by a private individual (also known as a relator) to recover losses on behalf of a public entity. *Qui tam* actions have been codified by federal and state "false claims" statutes. These statutes typically require the relator to file the action under seal to allow the state an opportunity to review the allegations, conduct an investigation, and determine whether to proceed in the state's name. *Qui tam* actions only seek to recover losses for funds identified by the relators. They do not seek to recover losses for all clients of a custodial bank.

² See Erin McCarthy and David Benoit, *Shift In FX Trading Seen Damaging Banks' Revenues – Report*, THE WALL STREET JOURNAL (Feb. 8, 2011); Steve Daniels, *Fee fracas imperils profitable currency trading business for Northern Trust*, CHICAGO BUSINESS (Feb. 14, 2011).

³ See Carrick Mollenkamp and Jean Eaglesham, *SEC Deepens Probe of Forex Trading*, THE WALL STREET JOURNAL (May 24, 2011).

***Qui Tam* Actions and Government Investigations**

The first *qui tam* action to be unsealed against a custodial bank, *The People of the State of California v. State Street Corp., et al.*, alleged that State Street “raided the custodial accounts” of CalPERS and CalSTRS, “in a total amount exceeding \$56 million, by fraudulently pricing foreign currency (‘FX’) trades State Street executed for the pension funds.”⁴ Specifically, the California Attorney General (who is leading California’s action), alleges that State Street overcharged the funds by manipulating the actual FX rates incurred by State Street when executing the pension funds’ trades. Moreover, State Street is alleged to have disguised its conduct by entering false FX rates into State Street’s reporting system and then supplying the pension funds with reports that lacked time stamps. Providing time stamps would allow the funds to verify that the rate charged by the bank was consistent with the prevailing bid/ask spread at the time of the FX trade. Jerry Brown, then California’s Attorney General and now California’s Governor, called State Street’s practices an “unconscionable fraud.”⁵

Earlier this year, two similar *qui tam* actions against BNY Mellon were unsealed. First, on January 21, 2011, *Commonwealth of Virginia, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, was unsealed after Virginia’s Attorney General intervened in the *qui tam* action filed in that state.⁶ The complaint, which seeks \$150 million in damages, alleges that BNY Mellon intentionally charged several Virginia retirement funds false FX rates for transactions executed on behalf of the funds. Like State Street, BNY Mellon is alleged to have priced trades in a manner designed to allow the custodial bank to secretly profit from the spread between the actual FX rates paid by the bank and the false FX rates charged to clients. In discussing his decision to intervene in the action, Virginia’s Attorney General, Ken T. Cuccinelli II, stated that “[b]ased on the information the whistleblower provided and the information developed using the investigatory tools authorized in [Virginia’s Fraud Against Taxpayers Act], [he] determined that it was prudent to intervene in the case and protect the interests of the retirement fund beneficiaries.”⁷

While setting forth similar allegations, the second unsealed *qui tam* action against BNY Mellon, *State of Florida, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, provided

⁴ *The People of the State of California v. State Street Corp., et al.*, Case No. 34-2008-8457-CU-MC-GDS, p. 2 (Cal. Superior complaint in intervention filed Oct. 20, 2009).

⁵ Eric Dash, *State Street Bank Accused of Fraud by California*, THE NEW YORK TIMES (Oct. 20, 2009).

⁶ *Commonwealth of Virginia, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, No. CL-2009-15377 (Va. Cir. unsealed Jan. 21, 2011); *see also* Rosalind S. Helderman, *Cuccinelli intervenes in suit alleging pension fraud*, THE WASHINGTON POST (Jan. 27, 2011).

⁷ Rosalind S. Helderman, *Cuccinelli intervenes in suit alleging pension fraud*, THE WASHINGTON POST (Jan. 27, 2011).

further details surrounding BNY Mellon's FX trading practices.⁸ Specifically, the complaint details the steps BNY Mellon took to execute and conceal trades at post-execution rates. Most notably, the complaint revealed that BNY Mellon used a foreign-exchange computer system called "Charlie" and daily "reconciliation" calls between BNY Mellon's FX transaction desks to coordinate the selection of FX rates charged to clients.

Recognizing that custodial banks' FX practices may have resulted in similar harm to their funds, other states have begun to investigate FX trading practices. On June 13, 2011, Massachusetts Pension Reserves Investment Management board ("MassPRIM") released a report summarizing an 18 month long analysis of FX rates charged by BNY Mellon (between January 1, 2007 and May 11, 2011). The report reached the following conclusions:

- Mass PRIM' FX trades rank in the 9th (100= best) percentile.
- The FX rates charged to Mass PRIM cost 30.9 basis points compared to the mean cost of 4 basis points versus a peer universe.
- This difference resulted in an overcharge to Mass PRIM of at least \$20 million.

Mass PRIM has now extended its analysis back to 2000. The day after Mass PRIM's report was issued, Ohio's Treasurer, Josh Mandel, wrote to Ohio's Attorney General requesting that the Ohio AG open an investigation into whether the state's funds were charged unfavorable FX rates by custodial banks.

Additionally, the Los Angeles County Employees Retirement Association ("LACERA") has stopped using BNY Mellon to execute FX exchanges after officials charged the bank with manipulating FX rates. BNY Mellon responded to LACERA's criticism by claiming that customers, including LACERA, were always aware that BNY Mellon did not act as a fiduciary when executing FX transactions.⁹ Notwithstanding BNY Mellon's statements about the limited scope of its fiduciary obligations, on May 24, 2011, THE WALL STREET JOURNAL reported that the SEC was launching an investigation into BNY Mellon's disclosure of its FX trading practices to custodial clients.¹⁰ According to the JOURNAL, "[f]ederal securities regulators are taking a deeper look at the role of big banks in executing currency trades for clients. At issue is whether 'custody' banks . . . are overcharging public pension funds [for FX trades]." The JOURNAL specifically identifies BNY Mellon and State Street as targets of the SEC's probe.

⁸ *State of Florida, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, No. 2009-ca-4140 (Fla. Cir. unsealed Feb. 7, 2011).

⁹ See Carrick Mollenkamp, *Trading Dispute Divides BNY, Fund*, THE WALL STREET JOURNAL (March 11, 2011).

¹⁰ See Carrick Mollenkamp and Jean Eaglesham, *SEC Deepens Probe of Forex Trading*, THE WALL STREET JOURNAL (May 24, 2011).

Class Actions

Individual pension and retirement funds have filed actions seeking to recoup losses resulting from their custodial banks' FX trading practices. In the last few months, two class actions concerning FX trading have been filed against State Street and BNY Mellon. First, in February 2011, the Arkansas Teacher Retirement System filed a class action complaint against State Street.¹¹ The complaint effectively mirrored the allegations set forth in the California action and seeks recovery of improperly obtained proceeds from State Street's FX trading practices. Second, Kessler Topaz is representing the Southeastern Pennsylvania Transportation Authority ("SEPTA") in its class action against its custodial bank, BNY Mellon.¹²

Conclusion

The recently unsealed *qui tam* actions, government investigations and filed class actions have alerted pension and retirement funds to the possibility that their custodial bank has been using FX operations to secretly profit at their expense. As alleged in these actions, the use of manipulated FX rates and fabricated trading reports has effectively concealed the hidden losses custodial clients have been suffering for several years.

¹¹ See *Arkansas Teacher Retirement System v. State Street Corp., et al.*, Case No. 11-cv-10230 (D. Mass. Feb. 2, 2011).

¹² See *Southeastern Pennsylvania Transportation Authority v. The Bank of New York Mellon Corp.*, Case No. 11-cv-1628 (E.D. Pa. Mar. 7, 2011).