FX Hedging/ FX Mis-Selling

Abhishek Sachdev
30th September 2015
Warren Buffett

*But* …… The equity index options Buffett sold in 2008 generated $2.1bn in profits for Berkshire Hathaway in the first nine months of 2013.
Our Team

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  - Nationwide, HSBC
Services we provide

- Advice on new hedging for FX, Interest Rates and Commodities
- Advice on restructuring existing hedging
- Modelling and analysis of hedging structures
- Indication of derivative market pricing
- Expert Witness Assistance
Global FX Market

➤ $5.3 trillion per day!

➤ Largest market in the world (Perfect Competition theory)

➤ Level 1 – Banks / FIs
   ➤ Level 2 – Dealers / Brokers

➤ Trading

➤ Carry Trade
Why hedge? GBP/EUR

33% good or bad?
Why hedge? GBP/USD

20% good or bad?
Parts of FX Market

- $1.49 trillion spot transactions
- $475 billion in outright forwards
- $1.765 trillion in foreign exchange swaps
- $43 billion currency swaps
- $207 billion in derivatives
**Description**

- In return for paying an upfront premium, you hold a GBP put / USD call with a strike rate as specified in the table on the right

**Potential outcomes at expiry**

- If spot is at or below the strike rate, then the option expires *in the money* and you have the right but not the obligation to sell GBP / buy USD at the strike rate
- If spot is above the strike rate, then the option expires *out of the money* and you are free to sell GBP / buy USD at the prevailing spot rate

**Benefits**

- Full protection against unfavourable rate movements below the strike rate
- Full participation in favourable rate movements above the strike rate

**Points to consider**

- Must pay an upfront premium to enter the trade
- Effective Rate
  - The Effective Rate is the rate at which you would convert your currency, if the upfront cost of the option would have been embedded into the dealing rate rather than paid as an upfront premium

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**Indicative Pricing**

<table>
<thead>
<tr>
<th>Notional</th>
<th>USD 1 mio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expiry</td>
<td>1 year</td>
</tr>
<tr>
<td>Currency Pair</td>
<td>GBP/USD</td>
</tr>
<tr>
<td>Spot Reference</td>
<td>1.6500</td>
</tr>
<tr>
<td>Average Forward</td>
<td>1.6400</td>
</tr>
<tr>
<td>Strike Rate</td>
<td>1.6000</td>
</tr>
<tr>
<td>Premium (% of USD)</td>
<td>4.00%</td>
</tr>
<tr>
<td>Effective Rate</td>
<td>1.5360</td>
</tr>
</tbody>
</table>

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**Payoff Chart: Snapshot at Expiry**

Diagram not to scale
Description
- This structure offers protection from adverse rate movements, whilst offering the opportunity to participate in favourable rate movements, up to an upper limit (the trigger rate).

Potential outcomes at expiry
- If spot has not traded at or above the trigger rate at any time during the observation period, then at expiry...
  - If spot is at or below the protection rate, then you sell GBP / buy USD at the protection rate.
  - If spot is above the protection rate and below the trigger rate, you are free to sell GBP / buy USD in the spot market at the prevailing spot rate.
- If spot has traded at or above the trigger rate at any time during the observation period, then at expiry...
  - You sell GBP / buy USD at the protection rate.

Benefits
- Zero Premium Strategy
- Provided the trigger rate does not trade, you hold a GBP put / USD call.

Points to consider
- If the trigger rate trades during the observation period, you are knocked into a forward at the protection rate.

Indicative Trade Parameters

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notional</td>
<td>USD 1 mio</td>
</tr>
<tr>
<td>Expiries</td>
<td>12 monthly expiries</td>
</tr>
<tr>
<td>Currency Pair</td>
<td>GBP/USD</td>
</tr>
<tr>
<td>Spot Reference</td>
<td>1.6500</td>
</tr>
<tr>
<td>Average Forward</td>
<td>1.6400</td>
</tr>
<tr>
<td>Protection Rate</td>
<td>1.6000</td>
</tr>
<tr>
<td>Trigger Rate</td>
<td>1.7520</td>
</tr>
<tr>
<td>Observation period</td>
<td>One month before each expiry</td>
</tr>
</tbody>
</table>

Payoff Chart: Snapshot at Expiry

Diagram not to scale
**Description**

- The participating forward offers protection against adverse rate movements and a fixed percentage of participation in favourable rate movements.

**Potential outcomes at expiry**

- If spot is at or below the protection rate, then:
  - you sell GBP / buy USD at the protection rate.
- If spot is above the protection rate, then:
  - you sell GBP / buy USD in 50% of the notional at the protection rate and the remaining 50% at the prevailing spot rate in the spot market.

**Benefits**

- Zero premium strategy.
- Complete protection against adverse rate movements.
- Unlimited upside on 50% of your notional.

**Points to consider:**

- You are required to settle at least 50% of the notional at the protection rate under all circumstances.

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**Indicative Trade Parameters**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Notional</strong></td>
<td>USD 1 mio</td>
</tr>
<tr>
<td><strong>Expiries</strong></td>
<td>12 monthly expiries</td>
</tr>
<tr>
<td><strong>Currency Pair</strong></td>
<td>GBP/USD</td>
</tr>
<tr>
<td><strong>Spot Reference</strong></td>
<td>1.6500</td>
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<tr>
<td><strong>Average Forward</strong></td>
<td>1.6400</td>
</tr>
<tr>
<td><strong>Protection Rate</strong></td>
<td>1.5300</td>
</tr>
<tr>
<td><strong>Participation %</strong></td>
<td>50%</td>
</tr>
</tbody>
</table>

**Diagram not to scale**

**Payoff Chart: Snapshot at Expiry**

- **Protection At 1.5300**
- **Participation In 50%**
- **Spot Market**
Description
- On each fixing date during an observation period, spot is evaluated (at a specified time) against the protection rate and the lower barrier.
- This determines the amount of EUR accrued during the period (to be bought at expiry).

Accrual rules for expiry
- Every fixing date spot fixes below the Lower Barrier, you do not accrue any Notional.
- Every fixing date spot fixes at or above the Lower Barrier and below the Protection Rate, you accrue \((1/N)\) of Notional.
- Every fixing date spot fixes at or above the Protection Rate, you accrue \((2/N)\) of Notional.
- At Expiry, you have the obligation to buy the following EUR amount at the Protection Rate:
  - Reference Notional \(\times (m + 2n) / N\)

Where
- \(m\) = number of fixing dates spot fixes at or above the Lower Barrier and below the Protection Rate during the respective Observation Period.
- \(n\) = number of fixing dates spot fixes at or above the Protection Rate during the respective Observation Period.
- \(N\) = total number of fixing dates during the respective Observation Period.

Benefits
- Enhanced Protection Rate
- Eliminates risk of fast markets gapping through barrier levels and wiping all gains from the trade.

Points to consider
- Every business day spot fixes below the Lower Barrier, you do not accrue any Notional.
- Fixing above the protection rate, accrues double the notional at the protection rate.

Indicative Trade Parameters

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notional</td>
<td>€10m (at each expiry)</td>
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<tr>
<td>Expiries</td>
<td>12 monthly expiries</td>
</tr>
<tr>
<td>Currency Pair</td>
<td>GBP/EUR</td>
</tr>
<tr>
<td>Spot Reference</td>
<td>1.3200</td>
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<tr>
<td>Average Forward</td>
<td>1.3150</td>
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<tr>
<td>Protection Rate</td>
<td>1.3000</td>
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<tr>
<td>Lower Barrier</td>
<td>1.2295</td>
</tr>
<tr>
<td>Fixing Dates</td>
<td>Every business day, during observation period</td>
</tr>
<tr>
<td>Observation Period</td>
<td>One month prior to each expiry</td>
</tr>
</tbody>
</table>

Payoff Chart: Snapshot at Expiry

Diagram not to scale
Description
- A TAF is the equivalent of a series of ratio forwards that offer the opportunity to deal at a rate that outperforms the current market.

Potential outcomes at expiry (with reference to Indicative Trade Parameters)
- Intrinsic Value and Target Profit Accumulated are calculated.
- If Spot is below the Protection Rate and:
  - if Target Profit Accumulated < Target Profit Max Level, you sell GBP / buy EUR in the Notional amount, at the Protection Rate.
  - if Target Profit Accumulated >= Target Profit Max Level, you sell GBP / buy EUR in an apportioned notional, at the Protection Rate, such that Target Profit Accumulated = Target Profit Max Level at this expiry date.
- All remaining expiry dates are cancelled.
- If Spot is above the Protection Rate:
  - You are obliged to trade a larger amount of the notional at the Protection Rate, as per the leverage factor.
  - Intrinsic Value is zero and Target Profit Accumulated does not increase.

Trade Rationale
- Zero premium structure.
- Enhanced protection rate significantly outperforms the current market.
- Opportunity to crystallise up to 25 cents of profit.
- If the Target Profit Max level is met or exceeded and you are left unhedged, then you may enter into a new TAF agreement to re-hedge your remaining exposure at prevailing market rates.

Points to consider
- If, at any expiry, spot trades above the protection rate, you are obliged to trade a larger amount of the notional at the protection rate, as per the leverage factor.
- If at any expiry Target Profit Accumulated meets or exceeds Target Profit Max Level, then the structure is cancelled and you are left unhedged for remaining expiries.
### FX Derivatives - Out-performance TAF (cont.)

#### Indicative Trade Parameters

<table>
<thead>
<tr>
<th>Notional</th>
<th>EUR 10 mio (at each expiry)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exprires</td>
<td>12 monthly expiries</td>
</tr>
<tr>
<td>Currency Pair</td>
<td>GBP/EUR</td>
</tr>
<tr>
<td>Spot Reference</td>
<td>1.1500</td>
</tr>
<tr>
<td>Average Forward</td>
<td>1.1510</td>
</tr>
<tr>
<td>Intrinsic Value at each expiry</td>
<td>Max (0, (Protection Rate – Spot))</td>
</tr>
<tr>
<td>Target Profit Accumulated</td>
<td>Running Sum of intrinsic value up to and including current expiry</td>
</tr>
<tr>
<td>Protection Rate</td>
<td>1.2935</td>
</tr>
<tr>
<td>Target Profit Max Level</td>
<td>25 big figures</td>
</tr>
<tr>
<td>Leverage Factor</td>
<td>2x</td>
</tr>
</tbody>
</table>

#### Payoff Chart: Snapshot at Expiry

- **Above Protection Rate**: Must trade double notional at protection rate

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### Expiries

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot Expiry</th>
<th>Protection Rate</th>
<th>Intrinsic Value (cents)</th>
<th>Target Profit Running Sum (cents)</th>
<th>Target Profit Max Level (cents)</th>
<th>Remaining Profit (cents)</th>
<th>Leverage</th>
<th>Trade</th>
<th>Status</th>
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<tbody>
<tr>
<td>Fri 01-May-09</td>
<td>1.1500</td>
<td>1.2935</td>
<td>14.35</td>
<td>14.35</td>
<td>25.00</td>
<td>10.65</td>
<td>none</td>
<td>EUR10.00m at GBP/EUR1.2935</td>
<td>TAF Live</td>
</tr>
<tr>
<td>Mon 01-Jun-09</td>
<td>1.2000</td>
<td>1.2935</td>
<td>9.35</td>
<td>23.70</td>
<td>25.00</td>
<td>1.30</td>
<td>none</td>
<td>EUR10.00m at GBP/EUR1.2935</td>
<td>TAF Live</td>
</tr>
<tr>
<td>Wed 01-Jul-09</td>
<td>1.3000</td>
<td>1.2935</td>
<td>0</td>
<td>23.70</td>
<td>25.00</td>
<td>1.30</td>
<td>2.0x EUR20.00m at GBP/EUR1.2935</td>
<td>TAF Live</td>
<td></td>
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<tr>
<td>Mon 03-Aug-09</td>
<td>1.2200</td>
<td>1.2935</td>
<td>7.35</td>
<td>31.05</td>
<td>25.00</td>
<td>0</td>
<td>none</td>
<td>EUR1.77m at GBP/EUR1.2935</td>
<td>TAFed Out</td>
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<tr>
<td>Thu 03-Sep-09</td>
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<td>1.2935</td>
<td>6.36</td>
<td>27.40</td>
<td>26.00</td>
<td>0</td>
<td>none</td>
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<td>TAFed Out</td>
</tr>
<tr>
<td>Mon 05-Oct-09</td>
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<td>1.2935</td>
<td>14.35</td>
<td>51.75</td>
<td>25.00</td>
<td>0</td>
<td>none</td>
<td>none</td>
<td>TAFed Out</td>
</tr>
<tr>
<td>Thu 05-Nov-09</td>
<td>1.1000</td>
<td>1.2935</td>
<td>19.35</td>
<td>71.10</td>
<td>25.00</td>
<td>0</td>
<td>none</td>
<td>none</td>
<td>TAFed Out</td>
</tr>
<tr>
<td>Mon 07-Dec-09</td>
<td>1.1300</td>
<td>1.2935</td>
<td>16.36</td>
<td>87.45</td>
<td>26.00</td>
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<td>none</td>
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<tr>
<td>Thu 07-Jan-10</td>
<td>1.1600</td>
<td>1.2935</td>
<td>14.36</td>
<td>98.80</td>
<td>26.00</td>
<td>0</td>
<td>none</td>
<td>none</td>
<td>TAFed Out</td>
</tr>
<tr>
<td>Mon 08-Feb-10</td>
<td>1.1600</td>
<td>1.2935</td>
<td>13.36</td>
<td>112.16</td>
<td>26.00</td>
<td>0</td>
<td>none</td>
<td>none</td>
<td>TAFed Out</td>
</tr>
<tr>
<td>Mon 08-Mar-10</td>
<td>1.1400</td>
<td>1.2935</td>
<td>15.35</td>
<td>127.50</td>
<td>25.00</td>
<td>0</td>
<td>none</td>
<td>none</td>
<td>TAFed Out</td>
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<tr>
<td>Thu 08-Apr-10</td>
<td>1.1100</td>
<td>1.2935</td>
<td>18.35</td>
<td>145.85</td>
<td>25.00</td>
<td>0</td>
<td>none</td>
<td>none</td>
<td>TAFed Out</td>
</tr>
</tbody>
</table>
Daily Fix

- Historically – 1 minutes window across 4pm
- Now – 5 minutes
- Fines - $10bn of fines…ignoring civil litigation…
- UK example
  - A Barclays client had placed a stop loss order to sell GBP 77 million at the rate of 95 against another currency. The Barclays trader attempts to get the currency to trade at 97 so he could sell the full GBP 77 million to the client at 96.5. Barclays would profit from this stop loss order if the average rate they bought GBP in the market was lower than this stop loss order.
Manipulation graphical example (1)

During the fix

Price

12am | 12pm | 4pm | 12am

1) Traders submit a rush of orders during the fix window

2) The 4pm fix is set at a higher price
Manipulation graphical example (2)

Using internal confidential information to then place trades ahead of 4pm…

1) Trader places order with knowledge of an event later in the day

2) Increase in price means trader can make a profit
Manipulation graphical example (3)

Collusion

Price

1) Trades placed individually have little impact on the currency's value

2) Alternatively, trades placed simultaneously can affect the market price

Strength in numbers...
HSBC example

- UK (FCA) it said traders at HSBC had colluded with traders from at least three other firms to attempt to drive the fix for the sterling/dollar rate lower.
- It said traders had shared confidential information about client orders prior to the fix, and then used this information to attempt to manipulate the fix downwards.
- The sterling/dollar exchange rate fix fell from £1.6044 to £1.6009 in this particular example, making HSBC a $162,000 profit.
- Afterwards, traders congratulated themselves, saying: "Loved that mate... worked lovely... pity we couldn't get it below the 00", "there you go.. go early, move it, hold it, push it", "nice works gents..I don my hat" and "Hooray nice teamwork".
FX Derivative Mis-Selling

- Premiums paid/receivable (Beware ‘premium free’ ≠ cost free)
- Fees paid / receivable
- Break costs and mark-to-market (N.B not always the same thing)
- Contingent Liabilities
- Payments under structure
- Profit – what is fair? Industry conventions / FCA guidance
- Alternative products
- Hedging vs. Speculating vs. Greed
- Suitability / Appropriateness
Watch out for…

- ‘DIY’ Calculations – need to use appropriate systems
- Need a recommendation for alternatives
- Recent FCA guidance on break costs
- Was product really needed at all?
- What is reasonable? Replacement Product, full tear up, apology?
- Fact specific
- Consequential loss potentially the larger claim
FX Hedging Strategy

- What exactly is the exposure?
- What is the reporting currency?
- What is the existing hedging policy?
- Is there a budget rate?
- How certain are the anticipated currency flows?
- What are your competitors doing?
Final Thoughts

“It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning.”

– Henry Ford
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Forex derivatives misselling – what can you do when things go wrong?

30 September 2015
Typical scenario

- Companies needing foreign exchange for their businesses seeking to hedge against currency risk by entering into forward contracts so that they have fixed currency costs over the coming months.

- But banks and brokers have been persuading companies to enter into extremely complicated forex trades which are entirely unsuitable for ordinary businesses.

- Instead of helping to mitigate against currency risk, these contracts are speculative products which have the potential of leaving companies with enormous liabilities.
Characteristics of trades

- Very complicated trades – difficult even for experts to price!
- Companies may be locked into lengthy contracts (18 months or 2 years) with individual trades expiring each month and with high break costs to terminate.
- Ratio forwards – where, if the exchange rate reaches certain trigger points, companies may find themselves having to buy, for example, double the currency they require.
- Downside risks are potentially unlimited if exchange rates move the wrong way.
Characteristics of trades

- Little upside – trades may be “knocked out” or terminated if the exchange rate reaches a certain level. If the trades are knocked out, companies may have to purchase currency at or below spot rates.

- Trades may also be “knocked out” if a predetermined “in the money” target, accumulating each month, is exceeded. These are known as TARFs (Target Redemption Forwards) or TARNs (Target Accrual Redemption Notes).

- Pressure to restructure to avoid “knock outs” – better short term rates at expense of worse terms further down the line.
Possible causes of action

- Statutory breach of duty?
- Negligence
- Best execution
- Forex manipulation
Statutory breach of duty?

- FCA rules (Conduct of Business Sourcebook)
- Examples of COBS rules:
  - Communications need to be “fair, clear and not misleading”
  - Risks and benefits equally presented
  - Advice as to suitability of investment (where advice provided)
- Legal action may be brought to compensate for losses, but only if you are a “private person” (section 138D FSMA)
Negligence

- The bank may owe the customer duties of care at common law to advise and/or to provide complete and accurate information to the customer in respect of the contracts. Examples:
  - not to recommend derivative contracts which were unsuitable and/or inappropriate
  - to explain the nature and effect of the contracts
  - to ensure that the information was complete and accurate
  - to inform as to the risks involved, in particular in relation to potential losses, and
  - to inform as to the effects and risks of restructuring the contracts.
Disclaimer clauses

- The bank’s terms and conditions relating to the contracts are likely to include disclaimer clauses, that it is not providing advice to the customer.

- Bank likely to rely on those disclaimers and argue that they should be regarded as “basis” clauses, i.e. clauses which set out the basis on which the parties are deemed to have entered the contract.

- The bank would say that a basis clause prevents the customer from arguing that the bank was advising them, no matter what the bank may have said to the customer.
Basis clauses not exclusion clauses

- However, there is legal authority that basis clauses may not be effective if the bank knew that the basis was untrue. So if the bank was well aware that the customer was not taking its own advice or carrying out risk management, the bank would know the non-advisory clause did not reflect the reality of the situation.

- The customer could also argue that the disclaimers are not basis clauses but exclusion clauses. If they are exclusion clauses, then it is arguable that they were not reasonable under the Unfair Contract Terms Act 1977.

- It could be argued that the clauses were unreasonable because the customer was in no position to calculate the potential risks and costs whereas the bank had sophisticated systems available to do this.
Duty to provide full and accurate information

- Even if the bank’s disclaimer clauses are effective in preventing an advisory relationship arising, the bank could still be liable for negligent misstatement if:
  - if it explains a product but does not give that explanation fully, accurately and properly.

- The bank is not under a duty to ensure the client correctly understood the information provided to him or its implications or consequences, or to ensure that he took an informed decision.

- *Crestsign v NatWest [2014] EWHC 3043 (Ch)*

- Appeal hearing set for April 2016
Recovery for negligence

- If it can be proved that the bank was in breach of its duty of care, recovery of all the losses suffered by the customer could be sought on the basis that, if the bank had complied with its duties, the customer would not have entered into such transactions.
Best execution

- The bank may have been in breach of its contract with the customer in that it failed to comply with its best execution policy.

- Banks are under a statutory requirement to provide its Retail Clients with “best execution”, i.e. to sell such clients products at the market rate.

- A successful claim could result in the customer being able to recover the difference between the price at which the products were sold and the appropriate market price they should have been sold at.
Best execution

- If the customer is not a Retail Client as defined by the FCA, it will not be entitled to this statutory protection and it will have to see whether the bank’s terms and conditions included a contractual “best execution policy”.

- If so, it might be possible to claim that the bank had not complied with its contractual policy if the bank had made excessive profits from the transactions.
Forex manipulation

- The FCA’s findings that several banks were guilty of manipulating the forex market may allow a further claim by the customer.

- Applicable to:
  - RBS
  - HSBC
  - Barclays
  - JP Morgan
  - UBS
  - Citibank
Forex manipulation

- The best claim would be that the customer entered into the transactions relying on an implied representation by the bank concerned that the forex rates were properly and honestly calculated and, had the customer known that the rates were being manipulated by the bank, the customer would not have entered into the contracts in the first place.

- On that basis, the customer should be put back in the position it would have been in had it not entered into the transactions with the bank, so all the contracts with the bank should be cancelled and any losses suffered by the customer as a result should be refunded.

- An alternative claim would be that the customer should be able to recover losses it suffered as a result of the manipulation – more difficult to prove but potentially benefiting from multiplying effect of contract triggers.
Our experience of the practicalities of bringing claims

- Complexity of the trades
- Difficulty of pricing
- Obtaining information from the banks
  - Subject Access Requests
  - Contractual documents
- Disclosure an opportunity for settlement
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