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Probing Foreign Exchange Transactions At Custody Banks

--By Susan L. Shin and Bret Finkelstein, Arnold & Porter LLP

Law360, New York (June 15, 2011) -- In recent weeks, the U.S. Securities and Exchange Commission and other regulators have joined several state attorneys general in investigating State Street Bank and Bank of New York Mellon's foreign exchange transaction practices.[1]

The SEC's foray into the foreign exchange market has interesting implications for the pending civil litigations that have been brought by various state public pension funds against the custody banks, as well as for the depth and breadth of the scrutiny this market will undergo in the coming months.

The Lay of the Land to Date

News of the SEC's investigation came just weeks after Massachusetts Secretary of the Commonwealth William F. Galvin began a similar investigation of State Street. BONY has also been the subject of similar inquiries from a number of state attorneys. Although the SEC has just recently commenced its inquiries, civil litigation is well under way in several states.

Public pension funds in states including California, Florida, Virginia, Arkansas and Pennsylvania have all filed suit against State Street and BONY asserting that the banks have violated state fraud laws by engaging in improper practices, including overcharging the funds for trading in the $4 trillion-a-day foreign exchange market.[2] Several other states, including Illinois, have also investigated similar claims. Washington State has settled a foreign exchange claim with State Street, the only state thus far to have done so.

The Civil Allegations by Pension Funds

The states, on behalf of their public pension funds, allege that the custody banks have been improperly pricing foreign exchange transactions.

The funds, due to the volume of currency transactions they routinely make, often entered into what are called "indirect" or "non-negotiated" currency transaction contracts with the banks. Under these private agreements, the banks oversaw the currency transactions from start to finish, with no negotiation regarding the rate at which the conversion took place. The funds allege that the banks were required to obtain the best possible conversion rates on the funds' behalf and that the failure to do so, and pocketing the difference, breached the banks' fiduciary obligations.

According to the complaints already filed, upon receipt of a foreign currency transaction request, the banks executed trades to fill the request at the then-prevailing conversion rate.[3] This is not the rate the banks charged the funds, however. Instead, it is alleged that the banks monitored the rates throughout the remainder of the day and ultimately charged the funds the least favorable rate available.

The banks are alleged to have taken the profit on the spread between the actual rate at which the trade was executed and the less-favorable rate that they charged the funds. The funds claim that while these individual spreads were often small and insignificant standing alone, the volume of currency transactions at the banks allowed for a tremendous profit.

The banks allegedly were able to engage in this practice because they historically have not time-stamped the currency transactions. Thus, as long as the price the banks charged the funds was within the range of available rates during the day the transaction occurred, the funds claim that they had no way of knowing whether they obtained the best price.

The banks, while not specifically denying the practice, have denied that they engaged in any illegal or fraudulent activities.[4]

Key Issue: Whether a Fiduciary Duty Exists

Foreign currency trading is not a highly regulated area and transactions are conducted over the counter. The pricing of currency transactions are governed by contracts between the custody banks and the funds, which do not appear to prohibit the practice and seem to allow broad latitude as to the prices the banks may charge the funds for currency transactions. Therefore, the banks may be technically right — unless, that is, a court determines that the banks owed their fund clients a fiduciary duty.

The issue of whether the banks owed a fiduciary duty to their clients will be hotly litigated in the civil cases. Broker-dealers certainly owe their customers a duty of fair dealing, which includes the duties to execute orders promptly, disclose certain material information, charge prices reasonably related to the prevailing market, and fully disclose any conflicts of interest.[5]

Similarly, broker-dealers owe their customers a duty of best execution which requires that the broker-dealer seek to obtain the most favorable terms available under the circumstances for their customers' orders.[6] But it is not clear whether the banks, which are not registered brokers or dealers, owed the same duties to the funds. Nor is it clear whether the banks were obliged to act as agents of the funds or if the banks were permitted to act on their own behalf pursuant to arm's-length agreements.[7]

The SEC's recent involvement is interesting and significant in a few respects. It is certainly welcome news for the funds in the pending civil litigations, as the SEC's probe into the foreign exchange transactions at the banks suggests a view by the agency that (1) certain duties, fiduciary or otherwise, were owed to the funds by the banks, and/or (2) some kind of deception or concealment may have been involved in the transactions, and such deception would fall within the purview of the anti-fraud provisions in the securities laws. These are the highly factual inquiries that the SEC is likely investigating, probably with the assistance of the CFTC.

But the basis for the SEC's jurisdiction over the issue is far from clear. The SEC does not oversee the foreign-exchange market. The bank entities named in the civil complaints (and presumably the entities investigated by the SEC) are not "brokers" or "dealers"[8] as defined by the Exchange Act, so the banks would not normally fall within the SEC's domain.

Further, Section 3(a)(10) of the Securities Act of 1933 specifically exempts "currency" from its definition of a "security," so there is a question as to whether a "security" that would subject these transactions and/or practice to the anti-fraud provisions of the securities laws is even implicated.

Implications of the SEC's Investigation

In any event, the SEC's interest in the banks' foreign currency practices suggests that broader scrutiny may be looming in the coming weeks and months. While State Street and BONY have thus far been the only subjects of the inquiries and litigation, the SEC's involvement may be indicative of a deeper industrywide probe.

Investment managers and other interested parties will likely receive subpoenas, if they have not already, related to the government investigations and ongoing civil litigation. In addition, we can expect that the banks' other clients, beyond the government pension plans that have already filed suit, will pursue litigation if they fall within the category of clients that relied on the banks to obtain foreign exchange pricing on their behalf.

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[1] See State Street Corp., Quarterly Report (Form 10-Q), at 65 (May 9, 2011).

[2] See, e.g., Complaint in Intervention, California ex rel. Edmund G. Brown, Jr. v. State Street Corp., No. 34-2008-00008457-CU-MC-GDS, 2009 WL 3444487 (Cal. Super. Ct. filed Oct. 20, 2009); Ex Rel. Complaint for Violation of the Virginia Fraud Against Taxpayers Act, Virginia ex rel. FX Analytics v. Bank of New York Mellon Corp., No. CL-2009-15377, 2009 WL 7400102 (Va. Cir. Ct. filed Oct. 23, 2009).

[3] See, e.g., Complaint in Intervention, California ex rel. Edmund G. Brown, Jr. v. State Street Corp., supra note 3, at ¶¶ 24-37 (describing terms of agreements); Ex Rel. Complaint for Violation of the Virginia Fraud Against Taxpayers Act, supra note 3, at ¶¶ 16-69 (describing terms of agreements).

[4] See, e.g., State Street Defendants' Verified Answer to Plaintiff's Complaint in Intervention, California ex rel. State Street Corp., No. 34-2008-00008457-CU-MC-GDS (Cal. Super. Ct. filed Apr. 12, 2010).

[5] See Div. of Trading & Mkts, U.S. Sec. & Exch. Comm'n, Guide to Broker-Dealer Registration (2008). These duties derive from the antifraud provisions of the Securities Exchange Act of 1934 (the "Exchange Act"), including: (1) Section 9(a) which prohibits particular manipulative practices regarding securities registered on a national securities exchange; (2) Section 10(b), a broad provision which prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security; (3) Sections 15(c)(1) and 15(c)(2) which apply to the over-the-counter securities markets; (4) Section 15(c)(1), which prohibits broker-dealers from effecting transactions in, or inducing the purchase or sale of, any security by means of "any manipulative, deceptive or other fraudulent device"; and (5) Section 15(c)(2), which prohibits a broker-dealer from making fictitious quotes.

[6] Id.

[7] In a recent motion to dismiss a purported class-action suit, State Street asserts that it did not owe its pension-fund clients a fiduciary duty with respect to these contracts. Memorandum in Support of Defendants' Motion to Dismiss, Arkansas Teachers Ret. Sys. v. State Street Corp., No. 1:11-cv-10230-MLW (D. Mass. filed June 3, 2011).

[8] Section 3(a)(4)(A) of the Exchange Act defines a "broker" broadly as any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(5)(A) of the Exchange Act generally defines a "dealer" as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.