HOW TO DEAL WITH TRANSNATIONAL MARKET ABUSE? – THE CITIGROUP CASE*

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Abstract: *The aim of this paper is to illustrate the difficulties that arise out of situations of transnational market abuse, focusing in a real-life, and particularly well-known, case, which received extensive media coverage at the time in several European countries.*

Summary: Introduction. 1. The Citigroup case. 2. Reactions of national Regulators. 3. Lack of coordination between national Regulators. 4. Lessons for the future.

INTRODUCTION

There are no longer internal financial markets, yet national Regulators still exist. Whenever it is necessary to deal with cases of transnational market abuse, these Regulators have to start investigatory proceedings simultaneously in the various jurisdictions, whilst at the same time potentially being in breach

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** The opinions expressed are from the author and may not be ascribed to the Portuguese Competition Authority.

of the *ne bis in idem* principle (supposing that this principle is not limited by sovereignty boundaries[1]).

The aim of this paper is to provide an example of the difficulties that arise out of situations of transnational market abuse. This is a real-life, and particularly well-known, case, which received extensive media coverage at the time in several European countries.

The following facts are explained according to the Final Notice of the British Financial Services Authority (FSA), dated 28 June 2005, which imposed a financial penalty on Citigroup Global Markets Limited (hereinafter: "Citigroup")[2].

1. THE CITIGROUP CASE

In July 2004, the Citigroup put pressure on its European government bonds trading desk (hereinafter: "Desk") to increase profits[3]. Accordingly, the Traders on the Desk identified a trading opportunity by calculating the aggregate firm bids and offers on the MTS[4]. In particular, the Traders realized that in recent months liquidity had been increasing in the MTS while the bid/offer spread had narrowed. In addition, they noticed that the correlation between the Eurex and the MTS made these markets very similar, therefore allowing for extremely efficient cross-trading. Those observations were very useful for the Traders to implement a trading strategy. So, the Traders reconfigured their software for connecting to the MTS in a way that would enable them to submit multiple orders to be submitted across all MTS platforms, to capture all the bids within a specified price range almost instantaneously. This application

1 See Eser & Burchard, 2006: 505.

2 Online at: http://www.fsa.gov.uk/pubs/final/cgml_28jun05.pdf (last accessed 5 May 2010).

3 Trading in government bonds in the Eurozone is undertaken in two markets, the cash market and the futures market. At the time the facts occurred, trading on the cash market was mostly conducted via electronic platforms, such as the *Mercato Telematico dei Titoli di Stato* (MTS), and also the *BrokerTec*. The futures market was primarily via the European Exchange Organization (Eurex), where medium and long-term government bonds were traded.

In the government bonds market, the formation and trend in prices is closely inter-linked in the cash and futures markets, to such an extent that the two markets often behave as if they were a single one. It was for that reason that Citigroup, like other banks, was able to calculate the prices of the various bonds on the cash market via price feeds from the Eurex.

4 The MTS, which was subdivided into several national platforms, was a quote driven market, that is, a market where all participants, with the status of market makers, were required, for certain minimum periods each day, to provide bid and offer quotes (in terms of price and volume) in respect of specified bonds. The MTS was a wholesale government bonds market with high liquidity, great depth, competitive prices and a narrow price interval.

became known as the "spreadsheet", and was also nick-named "Dr. Evil" by its creators[5]. Once in possession of this instrument, the Traders defined a strategy involving three steps: firstly, the creation of a "basis position" over a period of days made up of a long position in cash bonds (i.e. the setting up of a position for posterior selling) and a short position in futures (i.e. preparation of a position for posterior buying); secondly, the subsequent close out of the short futures position by buying futures contracts on a day when they expected that the market in government bonds would be undervalued; and, thirdly, the quick sale of the long cash position on the MTS, using the spreadsheet to capture all firm bids for a large number of bonds within a specified price range. The first stage was implemented gradually from 20 July 2004 onwards and the cash market purchases were made at a good price. The second and third stages of the strategy were put into practice on 2 August 2004[6]. Between 09:12 and 10:29, the Traders completed the second stage, undoing the short futures position by buying up a total of 66,214 contracts on Eurex, after an increase in quotation had been confirmed which reached the session maximum for both medium and long-term government bonds. Given that the prices of bonds in the cash market and futures markets were closely linked, the prices of bonds in the cash market also rose. The Traders therefore began the third stage, that is, the simultaneous sale of a very large number of bonds on the MTS. At around 10:29, the Traders set the spreadsheet in motion, the result of which was that they generated 188 sales orders which were submitted in 18 seconds. By means of these orders they targeted 119 different government bonds in 11 national MTS platforms[7]. The final result of using the spreadsheet was €11.3 billion nominal value of bonds sold on the MTS. Leaving asides reasons and not mentioning various incidents, the Traders thus guaranteed an overall profit of £9,960,860 (that is, €15,091,068.00, at the £/€ exchange rate of 0.66005 recorded for 2 August 2004)[8].

5 Dr. Evil is one of the characters in the Austin Powers movies.

6 This day was chosen because the prices of government bonds traded in the Far East showed a growth trend, after rumours suggesting a terrorist attack in the USA was imminent had been dispelled, and because it was believed that, as a result, this growth trend would be replicated in Europe, where markets had not yet opened, due to the time difference.

7 Metaphorically, one might say that it was the equivalent of the effect of the sudden opening of a dam's sluice gates.

8 The exchange rate was taken from the historical series available on the Bank of Portugal website: www.bportugal.pt (last accessed 5 May 2010).

2. REACTIONS OF NATIONAL REGULATORS

The Citigroup case had connecting factors with several European legal orders: Citigroup's headquarters were in London, the Eurex futures market was based in Frankfurt (Main), and the MTS was an Italian trading system, although operated through different national platforms by subsidiaries. It is not surprising, therefore, that the Citigroup case gave rise to investigations by several national Regulators of financial markets.

Not all of the Regulators acted against Citigroup, but seven of them analyzed the case and the following (in alphabetical order) took measures: Germany, Italy, Portugal and the United Kingdom.

The German *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) reported the case to the Public Prosecutor (*Staatsanwaltschaft*), of Frankfurt (Main), with a view to initiating criminal proceedings in relation to the crime of market manipulation (*Marktmanipulation*)[9]. Due to the absence of criminal liability for legal persons in German law, the action was lodged against the six Traders who had implemented the trading strategy in question. The Public Prosecutor did not take long to shelve the case, with this occurring on 21 March 2005[10]. Also in Germany, the Eurex launched an enquiry, but concluded that Citigroup's trading had not breached any of the rules of that market.

Having concluded preliminary investigations (*accertamenti*), the Italian *Commissione Nazionale per le Società e la Borsa* (Consob) handed the case to the Public Prosecutor (*Procura*) of Rome in March 2005. On 20 July 2007, the *Procura* finally charged the aforementioned six Traders and also the Head of the Desk with the crime of market manipulation (*agiotaggio su strumenti*

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9 At the time the facts occurred (2 August 2004), the 4th Law on the Promotion of the Financial Markets (*4. Finanzmarktförderungsgesetz*), of 21 June 2002, was in force, which revised the Securities Market Code (*Wertpapierhandelsgesetz* – WpHG). The prohibition on market manipulation appeared in 20a(1), with criminal sanctions (*Strafbestimmungen*) being established in 38(1).

Regarding the more recent development of the Criminal Law of the German Securities Market, see Vogel, 2007: 733-735.

10 "Frankfurt prosecutors yesterday cleared six Citigroup traders of criminally manipulating the eurozone government bond market, lifting one of the biggest threats overhanging the US bank's reputation. But the ruling prompted an angry response from BaFin, Germany's financial market watchdog, which said it stood by its preliminary finding that Citigroup traders had manipulated Eurex government bond futures. [...]. Doris Möller-Scheu, of the Frankfurt prosecutor's office, said: 'Unlike BaFin, which found grounds for charges, the prosecutor is of the opinion that a charge of criminal price manipulation against those under investigation cannot be legally established'." (Munter & Batchelor, 2005: 22 March). See also Esteves & Kripphal, 2005: 23 March.

finanziari)[11]. There is also no criminal liability for legal persons in Italian law, and hence the Bank was left out of the criminal proceedings. The trial was due to begin on 30 October of the same year, but we have been unable to confirm whether there have been any developments since that date. The Italian MTS also commenced proceedings against Citigroup in due course, the conclusion being that the Bank had breached the rules of that market, which led to its suspension for a period of one month.

In regulatory offence proceedings (Case no. 56/2004), the Portuguese *Comissão do Mercado de Valores Mobiliários* (CMVM) considered that Citigroup had repeatedly breached the duty to defend the market (Article 311 of the Securities Market Code) and, as a result, imposed a fine on it of €950,000, together with the additional sanction of publication of the conviction. This fine has yet to be paid, owing to the judicial review requested by Citigroup on 16 June 2006. The appeal trial has not yet been scheduled in the Lisbon Small Claims Criminal Court (*Tribunal de Pequena Instância Criminal de Lisboa*).

After an investigation that lasted eighteen months, the British FSA eventually concluded that Citigroup's trading strategy based on the setting up of very substantial long positions followed by abrupt closure constituted a risk to ordered trading on the MTS[12] and, consequently, imposed a financial penalty of around 14 million pounds (21 million euros), which was at the time the second-highest ever imposed by the FSA. The overall amount of the financial penalty was calculated on the basis of around 10 million pounds in relinquishment of profits and 4 million pounds of additional penalty, which was punitive in character. The penalty has already been paid, particularly since the FSA's final decision was negotiated with Citigroup and, for this very reason, judicial review of the decision is not possible.

3. LACK OF COORDINATION BETWEEN NATIONAL REGULATORS

The Citigroup case demonstrates that the different national Regulators were far from agreeing with each other, let alone managing to build a common case in a situation in which all of them had jurisdiction, but in which it would be very difficult to accept that each of them might, simultaneously, impose independent

11 Pursuant to Art. 181 of the *Testo Unico Finanziario – Decreto Legislativo 24 febbraio 1998*.

12 See Herbst & Rutter, 2005: 65-68.

sanctions, leaving aside the issue of whether those sanctions ought to be criminal or administrative or whether applied to legal or to natural persons.

It seems that the British FSA was the most effective Regulator, since it not only managed to get Citigroup to pay the financial penalty applied to it, but also, and more importantly, to admit that it had breached principles 2 and 3 of the Principles for Businesses set out in the FSA Handbook[13]:

– Principle 2: "A firm must conduct its business with due skill, care and diligence";
– Principle 3: "A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems".

This principle-based approach is the essence of the regulatory system (i.e. administrative sanctions) of the British FSA, in force since 1 December 2001.

4. LESSONS FOR THE FUTURE

Was the financial penalty the British FSA imposed on Citigroup too lenient? Would it have been better to seek criminal liability for the crime of market manipulation, as the German BaFin and Italian Consob intended? In that case, who ought to have been called to respond to the charges? Should it only have been the Citigroup Traders and the respective Head of Desk, given that there is a lack of criminal liability for legal persons in the German and Italian legal systems, and, indeed, in the Portuguese legal system (the latter only with regard to crimes against the financial market)? Or, on the contrary, should nobody have been called to respond to any charge, since the Traders in fact had a good idea to revive the MTS, and Citigroup, as a result, simply took advantage of the features of the market, as some analysts have written?[14]

These are all good questions, although it is not necessary to find an immediate answer to them. What is important here is to stress that the Regulators and Judicial Authorities of the different European countries may never again deal with these cases independently of each other, on a strictly national basis.

13 See *FSA Handbook*, online at: http://www.fsa.gov.uk/pages/handbook/ (last accessed 5 May 2010).

14 In this sense, see Gapper, 2005.

To quote Carlos Conceição: "A coherent and effective European cross-border response to market abuse requires having, at least a common approach across all member states to:

– What constitutes market misconduct?
– What should be investigated?
– Who should investigate?
– How should misconduct be investigated?
– What action should be taken?"[15]

Although the Citigroup case occurred before the transposition of the Directive on Market Abuse[16] into the legal systems of the various European countries, the truth is that the problems remain the same today and are not merely solved as a result of harmonization of the legal systems. Indeed, harmonization in specific areas does not overcome the profound differences that exist between the legal systems of the various European countries. Yet, none of those differences would impeach the possibility of seeking a coordinated effort between the Regulators at the level of the Committee of European Securities Regulators (CESR) or, better still, the possibility of organizing meetings merely between the Regulators involved in which the best approach to take in situations where joint action is required can be decided. Once they have agreed on which Regulator should take a lead in the particular case, according to flexible criteria to be analyzed *ad hoc*, the Regulators ought to follow the strategy of the leading jurisdiction and should not call upon the principles of the respective legal systems to impede a single action. In particular, they should not invoke the principle of legality to justify handing the case to the Public Prosecutor, thereby themselves losing control of the actual investigation. If the Regulators cannot come to an understanding, in practical terms they will ultimately allow those carrying on abusive market practices to adopt strategies in search of the most favourable jurisdiction (forum shopping) and to then parade before the competing national jurisdictions the argument that they cannot be tried more than once for the practice of the same facts, not even at the transnational level.

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15 See Conceição, 2006: 32-33.

16 Directive no. 2003/6/EC, of the European Parliament and of the Council, of 28 January, on insider dealing and market manipulation (market abuse).

Although the foundation of true European agencies within the framework of the forthcoming reform of the EU financial supervisory organization[17] is not envisaged – which without any doubt would strengthen the prosecution of transnational market abuse cases –, hopefully the new European Securities and Markets Authority (ESMA)[18], i.e. the planned substitute for the current CESR, will have the power to coordinate and even to decide which of the national Regulators have to take action in particular transnational market abuse cases.

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