Remarks for Deloitte Capital Markets Seminar

5th April 2019

Wholesale Market Manipulation

I want to start by telling you a story.

The best stories in my childhood always started with the words "It was a dark and stormy night…"

So it is fortunate that in this real life story it really was a dark and stormy night. The date is Sunday 20th February 1814. The place is Dover. Sunset fell shortly after 5.20pm in the afternoon. The day had been bitterly cold, windy and misty; and the night followed suit, so the weather was truly a pathetic fallacy for the human drama that was about to unfold.

Two locals, John Marsh and Thomas Gourley were disturbed late that evening, as they shared a pipe in the Ship Inn by a hammering at the door and the sound of a voice demanding a *post chaise* carriage to London.

Dover at this time was on constant alert for news from the Continent. Napoleon had been defeated in his disastrous Russian campaign in 1812, and again at Leipzig in October 1813, but was still at large with significant forces in Northern France. While no-one in England seriously feared an invasion, Napoleon at the head of an army was nonetheless a potent threat. Indeed, Napoleon had thoroughly trounced the Coalition forces led by Blücher on six occasions in battles across Northern France in the previous 3 weeks. So, at this stage, Britain waited news of Napoleon's next move with nervous anticipation.

The source of the knocking turned out to be a stranger, dressed in a soaked greatcoat over an unusual-looking, battle scarred and very muddy uniform, who stated that he was Lieutenant-Colonel du Bourg, just arrived from France with the most important news that had to be delivered immediately to Admiral Foley, Commander of the south coast naval forces at nearby Deal.

Had they looked more closely, some of the Dover residents, who had gathered at the disturbance, might have noticed that the battle-stained uniform was in fact streaked with boot-black; and they would have been even more surprised some minutes earlier to have seen the stranger standing in the nearby millstream throwing water over his coat to simulate a sea-soaked Channel crossing.

But unaware of these details, the locals provided Du Bourg with the wherewithal to write to Admiral Foley, and his letter set out the stunning news that Napoleon had been defeated in battle: "Bonaparte was overtaken by a party of Sachen's Cossacks who immediately slayed him and divided his body between them. General Platoff saved Paris from being reduced to ashes…an immediate peace is certain" he wrote.

Du Bourg's letter was delivered to Admiral Foley at 3am, but the poor weather prevented its transmission to London via the primitive telegraph system then available. Nevertheless, the sensational news started to spread by word of mouth, across and inland from the south coast, even at this early hour. And Du Bourg left for London personally, changing horses and carriage several times before arriving in the capital early on Monday 21st.

While Du Bourg was *en route*, two gentlemen claiming to be French officers of the pre-Napoleonic Bourbon government appeared in Dartford, with even more lurid details of the demise of the Emperor, also demanding transport to the capital.

The combined effect of the overnight rumours and the arrival in the early morning of two separate parties with news of impending peace created pandemonium among Londoners and on the Stock Exchange. Large crowds gathered outside the Mansion House hoping for an official announcement from the Lord Mayor. In the course of the day government stocks – gilts – rose in value by an astonishing 20 per cent.

Inevitably, as the day wore on with no further corroboration of this dramatic turn of events, suspicion mounted and disappointment grew. It was confirmed later in the afternoon that Napoleon was in fact alive and that Lieutenant-General Baron Sachen's Cossacks had been engaged elsewhere. Gilt prices fell sharply and many investors caught up in the frenzy of the morning lost large sums of money.

In the investigation that followed it transpired that only four individuals had sold gilts on that Monday – Sir Thomas Cochrane (10th Earl of Dundonald, a distinguished Naval hero, MP and member of the Order of the Bath), Andrew Cochrane Johnstone (ex-Governor of Dominica, MP for a rotten borough in Cornwall and Thomas's uncle), Richard Butt (a stockbroker) and John Holloway (a wine merchant).

These four owned almost £1m in holdings of gilts – equivalent to £50m million today - at the start of the day's trading, most of which had been purchased the previous Friday. They could have made profits of between £5 and £10m in today's money on their trading, if things had gone well; as it was they only netted about £0.5m – this was long before the days of best execution rules!

The four of them, and du Bourg, whose real name turned out to be Charles Random de Beringer, were tried at the Old Bailey. They were found guilty, fined, placed in the

public pillory at the front of the Royal Exchange and sent to prison for 12 months in the first ever successful prosecution in the English courts for market manipulation.

This true story is the first example that I am aware of in this country, in the modern capital markets era, of wholesale market manipulation. But the fate of the four conspirators, is interesting as well for another reason - which I will come back to later.

George Cruikshank, the celebrated cartoonist, published a cartoon at the time called "Gambling in the Stocks" depicting the incident in The Satirist, a sort of early nineteenth century Private Eye.

In the image, two sets of double stocks face each other. Thomas Cochrane and de Beringer face each other playing dice. Cochrane's naval connections are indicated by his uniform, cocked hat, knee-breeches and a grappling iron nearby. De Beringer's supposed Prussian origins are indicated by a huge black moustache, a sabre, green military coat and large jack boots.

Next to Cochrane sits his uncle, Andrew Cochrane Johnstone, wearing a tam-o'-shanter. Opposite him Holloway, the wine merchant, wears a barrel over his coat from neck to waist, with holes for the arms.

In the foreground a bull enters Fleet Ditch, followed by two "lame ducks", one using a stick, the other using crutches. They walk over papers inscribed "Consols" and "Omnium" – historical terms for government bonds - followed by a bear on its hind-legs walking on "Scrip".

Another pool inscribed "Sinking Fund" is stirred up by a man who has plunged in head first, leaving hind-quarters inscribed "Honor" and legs waving in the air.

In the middle distance a bull with a man's face and branded "J B" – a reference to John Bull - has tossed a little Napoleon high in the air so that he is about to fall on the spear of a grimly expectant Cossack.

On the right of the cartoon a *post-chaise* with four galloping horses and two postilions – a reference to the party that came from Dartford - is dashing down a hill, a man leaning out, wildly waving his hat and shouting "Death of Bounaparte!!" The *chaise*, inscribed 'H. Humbug & Co North Fleet', and horses are decked with branches of laurel; behind it are tied large bundles of 'Dispatches'.

Cruikshank's comprehensive ingenuity makes our satirists today seem rather prosaic in their efforts.

Of course, this was 200 years ago, involved relatively modest amounts of money and a small group of perpetrators.

Today, and the past decade, present a rather different picture. The cost to the banking industry, and the wider global economy, of recent market manipulation has been simply staggering.

In direct terms, 50% of the net profits of UK banks were disgorged in 2015 in fines and other penalties for market abuse of one sort of another. In the past 6 years, banks globally have paid $375 billion in conduct fines, about 80% of which related to wholesale markets. The Bank of England has estimated that if that money had been retained as capital it would have supported $5 trillion in bank lending to the real economy.

The fines, and the cost of the remediation work that went with them – which is not just financial – have not only been a problem for the short-term profits of a few banks. The penalties extracted have been of such a scale that they have hindered the recapitalisation of the banking system, and undermined the "investability" of banks which have struggled to generate dependable earnings in excess of their cost of capital. Andrew Bailey, CEO at the FCA, has described grappling with misconduct problems in the banking industry as the "second phase" of the recovery from the global financial crisis, equivalent in importance to the recapitalisation, de-leveraging and other de-risking measures taken in the "first phase" of prudential regulatory intervention from 2008-2013.

Indirectly, given the vital transmission mechanisms that wholesale FICC markets play in the global economy, market manipulation throws grit into the wheels of global growth with a multiplier effect much larger than just the damage to bank capital.

More seriously, manipulation of markets has also created long term costs for the banking industry through the systemic damage it has done to trust in financial services – not just trust in banks and bankers but in many other actors too - and the erosion it has caused of the social licence to operate that banks and others in the financial system need. Notwithstanding the huge financial costs already noted, this is the most damaging legacy of the recent crisis and the manipulative activity it revealed.

At FMSB we have made a study of the historical cases of market manipulation in an attempt to see if there are lessons that can be learnt from the past that might help in building better defences today.

This study of some 400 representative cases of manipulation, across 25 jurisdictions worldwide, confirmed that despite the regular and strenuous interventions of lawmakers and regulators, manipulators have in fact struck repeatedly over the past

two centuries across debt, equity, currency and commodity markets, both voice and electronic, using a relatively small number of techniques – about 25 in total which can be clustered into 7 categories – to carry out their mischief.

The implications of this study for market participants and their advisers and for regulators are huge. Focussing effort on this cluster of repeating patterns of behaviour should help both the private and public sector to bear down more effectively on malpractice with greater efficiency. For example, firms can use these insights to develop a taxonomy of (mis)conduct risks (as they often do for other types of operational, credit and market risk), use this to aid the design of surveillance systems, the training of staff in both front office and independent control functions, and the production of management information for senior management and governance fora.

Given this research, perhaps we should not be so surprised that the law used to prosecute Tom Hayes in 2014 for LIBOR manipulation was the same law used two centuries earlier to put Cochrane and de Berenger behind bars. But it is nevertheless striking.

We don't have the time here this evening for a complete discussion of the underlying reasons for repeated misconduct: they lie deep in the provinces of psychology, social science, philosophy and anthropology more than they do in regulation. But one thing I think we can say with certainty: good laws and sound regulation are a necessary, but not a sufficient, condition for fair and effective markets that are free of manipulation.

Another condition must also be fulfilled: namely that market participants have a clear understanding of how their day-to-day business practices are structured to support the best outcomes for the users of markets. Regulation isn't designed to describe these detailed business practices – and we should be very grateful that it doesn't prescribe them, as that would stifle innovation and create other problems. But given that is the case, market participants, both liquidity providers and liquidity users, need to take more responsibility for defining how wholesale markets should operate so as to deliver fair and effective, ethical results. Of course regulators have to endorse and support such efforts otherwise they may fail; but the initiative and drive for clear standards needs to come from the private sector, else it certainly will fail.

This of course is FMSB's mission.

Thank you for your attention. I am very happy to take some questions if there is interest.