

RBC Suit Seen as Warning to U.S. Banks

When the Commodity Futures Trading Commission alleged in April that Royal Bank of Canada traded with itself to sidestep Canadian tax laws, the accusations were confined to a few foreign actors swapping securities on a low-profile exchange.

RBC's troubles may have serious implications for American banks, however. Former regulators and industry attorneys warn that the case is likely a template for larger-scope CFTC trading enforcement actions.

"There's been a strong push for the division of enforcement to do more wash trading cases to expose the exchanges, because as you look at the result of Dodd-Frank, they're essentially putting a lot more regulatory oversight away from the exchanges," said a former CFTC official, who is now in private practice and did not want to be identified by name. "One way to do that is you end up bringing a case that says: 'Exchanges aren't really doing their jobs.'"

The CFTC's action reflects its effort to meet its Dodd-Frank Act mandate to expand its oversight of futures exchanges.

Wash trading, in which market participants create round-trip transactions in order to dodge taxes on gains or manipulate markets, is one activity primed for more scrutiny. The scope of the RBC case alone breaks from past wash trading suits, which targeted individual brokers, who generally settled for minor fines.

RBC's experience may suggest that the CFTC's new approach could catch other banks off guard. Observers say the rules on wash trading have sometimes been hazy or weakly enforced, particularly for large banks moving positions from one subsidiary's books to another's.

"[Y]ou have a lot of difficult questions on how to do it," and "the waters are very muddy," said Jerry Markham, a professor at Florida International University.

In its suit, filed April 2, the CFTC says a group of RBC executives orchestrated hundreds of millions of dollars in wash trades between subsidiaries solely to gain tax benefits. Bankers misled futures exchange officials by claiming the trades were legitimate market activity, the suit says.

The suit says RBC's tax strategy was centered on obtaining an offset against its Canadian taxes in an amount equal to the US taxes they paid on dividend income. George Michaels, founder of the tax compliance software company G2 FinTech, says that practice is permitted with other types of securities trading, but not with futures. RBC must have directed one subsidiary to go long on stocks and another to short the equivalent amount in futures, Michaels says. That wash trade would produce a "negative tax offset" that could be netted against profits produced by the bank during its normal course of business.

The suit against RBC should put U.S. banks on alert, Michaels says. The message is "if we find U.S. companies doing this, we'll come down on you like a ton of bricks," he said. "This was a shot across the bow."

The CFTC has previously shied away from looking at organizational wash trading allegations, legal records show. Its previous suits against banks have targeted individual traders for discrete conduct, sometimes at the request of clients. JP Morgan Securities settled a case in 2010 for \$140,000, on charges that a customer asked a broker to sell and then buy the same number of U.S. Treasury note futures on the same day. Cantor Fitzgerald paid \$100,000 in February 2011 to close out allegations that it conducted three wash trades involving natural gas futures contracts.

Yet with RBC, the CFTC has not singled out individual traders. Instead, it has argued that the bank used OneChicago, an otherwise moribund exchange for stock futures, in a coordinated effort to dodge market pricing. "They're basically saying all of this trading being done at OneChicago, it was fundamentally flawed," said Geoffrey F. Aronow, former head of the CFTC's enforcement division.

One wrinkle in the RBC case is that the commission appears to be focusing not just on the trading itself but on RBC's intent. The CFTC says senior members of RBC's central funding group created the bank's trading strategy of narrow-based index securities products and approved of such transactions made between RBC Europe Ltd. in London and the RBC Canadian Transit accounts in Toronto. Executives also approved and coordinated the day-to-day trading of single stock futures among two Caribbean RBC subsidiaries and the Luxembourg-based RBC Capital Markets Arbitrage.

A single stock future is a contract on a single stock, as opposed to an index. A narrow-based security index, according to the Commodity Exchange Act must have nine or fewer components, one of which must compromise more than 30% of the index weighting.

The CFTC suit says RBC bankers described as CFG Member 1 and CFG Member 2 directed employees in both Caribbean subsidiaries to buy the same SSF contracts that RBC CMA was selling. CFG Member 1 identified RBC CMA holdings and, by phone and email, directed traders in the Caribbean on which contracts to buy. Those wash trades were "equal and offsetting in size and price in the same contracts of the same delivery month," the suit says. Yet when officials of CME Group, which regulates and partly owns the OneChicago futures exchange, questioned the bank about the trades, which accounted for 87% of the market volume for SSF contracts, RBC said the idea for the trades "originated with the staff in our Bahamas office."

The allegations for the narrow-based securities index trades are similar to the SSF activity, except that RBC constituted 100% of the trading at OneChicago.

CME Group officials declined comment.

RBC called the charges "absurd" and vowed to fight the case in U.S. District Court in New York. It said in a statement that the commission was aware of the activity and that bankers sought guidance with the exchange before making the trades.

The transactions in questions were block trades, which are allowed by the commission. Block trades are large trades conducted off-exchange between two parties and then posted. When conducting a block trade, the two sides are prohibited from releasing the details to a third party and the pricing must be within the current market range.

RBC said the trades were "executed at competitive market pricing."

That RBC was so dominant in both SSF and NBI trading leads some experts to wonder if it believed its actions were safe. One former commission employee questioned why, if RBC operated an illegal scheme, it did so hiding in plain sight.

"If you're going to do it, I don't know why you would do it on a dormant exchange, because it's much easier to spot," said the former official, who asked not to be named.

Markham, who is writing a book on commodities and securities manipulation, including wash trading, argues that the commission has been inconsistent for decades in its past enforcement.

In a 1991 paper, Markham said courts have dismissed CFTC actions because the commission "had taken conflicting positions on what constituted a wash trade." Little has changed over the last two decades, Markham said, pointing to a debate in the courts about appropriate behavior in open and closed markets. He faults the CFTC for not providing a definitive standard for how subsidiaries may interact.

A commission spokesman declined to comment.

"Like a lot of concepts that sound basic, even wash trading can be more complicated," said Aronow, now a partner at Bingham McCutchen. "Here, the complaint suggests that, if the subsidiaries were making independent decisions, there wouldn't have been a problem."

There may be good reason for other banks to try to read the tea leaves of the RBC case. The CFTC's 2013 budget request seeks to increase staff within its enforcement division, increasing the staffing by 50 people, a 30% rise in head count. It expects a threefold increase in the number of exchanges and platforms under its purview by the end of 2013. Dodd-Frank calls for increased oversight of designated contract markets such as OneChicago. The CFTC is working on its proposed rules for DCMs. Specifically, those exchanges must now comply with new core principles as a condition of maintaining CFTC designation.

http://www.americanbanker.com/issues/177_105/CFTC-lawsuit-RBC-intra-bank-trading-futures-enforcement-1049777-1.html?zkPrintable=1&nopagination=1