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How Prosecutors Misconstrued OTC Market-Making Practices

By **Sujay Dave and George Oldfield** (June 25, 2019, 5:24 PM EDT)

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Recent federal court cases highlight the challenges involved in judging acceptable market-making behavior in over-the-counter markets.[1] In these cases, prosecutors interpreted trader bluster and barter as fraud, customary prehedging of pending OTC block orders as front-running, and self-interested principal trading as a violation of a market maker's inferred duty to a counterparty.

The standards applied to evaluate market-making behavior, however, should be consistent with established and customary protocols in OTC institutional markets. In these markets, haggling is the norm, prepositioning and forward sales are risk management techniques, and market makers trade for their own accounts to earn a profit by making buys and sells.

Here we describe how market makers work in various types of markets for financial instruments, and the reasons why mixing up exchange trading practices with well-established OTC trading protocols might be disruptive in OTC markets.

Role of Market Makers

In OTC markets, the market maker is a principal trader who buys from sellers at a “bid” price and sells to buyers at a higher “ask” price. The market maker's objective is to make a profit from the bid-ask spread.

Principal-based market making is a basic financial service that provides transaction immediacy to other traders and liquidity in financial markets. Market-making arrangements run the gamut, from rapid anonymous trading on exchanges, to sporadic bilateral OTC trading among institutions, to occasional one-off new issue underwritings.

Specific market trading protocols vary from market to market. In exchange markets, market makers offer to trade when a customer submits an order or requests a quote. An order may be submitted at whatever price currently prevails in the market (a market order) or for execution at a fixed price (a limit order). Limit orders are held by market makers for potential execution when the limit order price becomes competitive.

Institutional investors usually trade large blocks either by trading with an OTC market maker, by trading in an off-exchange order-matching market (a "dark pool") or by dribbling out small orders over an extended time in a retail market.[2] When a block trade market maker accepts a buy or sell order, it usually negotiates the price with its counterparty, while simultaneously searching for offsetting orders and hedging any portion of the block for which it has no offsetting order.

A conventional secondary market or derivative contract trading agreement between a market maker and its counterparties usually states that the market maker is not a fiduciary in its usual trading business.[3] A different arrangement usually holds in primary markets and secondary offerings for corporate securities, where the market maker is usually contracted to be a fiduciary agent for the seller.

In a primary market for corporate instruments, a market maker buys a large block of stock or bonds from an issuer and sells it to investors as a principal; this process is called underwriting. An underwriting contract may specify a fixed purchase price for the underwriter, with a higher fixed price for investors.

Alternatively, the issue may be distributed on a best-efforts basis, in which an underwriter sells to investors without guaranteeing a price. Unlike most market makers in the secondary market, an underwriter in the primary market is usually a fiduciary working on behalf of the issuer.[4]

A secondary offering is an underwriting transaction in which an investor that owns a very large block of an issue engages an underwriter to resell the block. In this activity, the underwriter is also usually a fiduciary. Thus, while a secondary offering is much like a block trade in size and execution, the contract governing the trading relationship between the seller and the market maker is different.

Secondary Markets: Order-Driven vs. Quote-Driven

Parallel exchange and OTC markets exist for many financial contracts, including securities and derivatives. Small orders are usually organized as exchanges, and market making on them is referred to as order-driven.

In contrast, large block orders of the same instruments are dominated by institutional investors trading OTC. In OTC markets, market making is mostly quote-driven.

In an order-driven market, market makers submit a flow of public buy and sell orders that compete directly with orders from other traders. Other traders may trade directly with each other if their order prices are better than a market maker's posted orders.

In contrast, in quote-driven markets, a potential trader requests a private quote from a market maker. A quote given is for both sides of the market with bid and asked prices, quantities on both sides and a time limit (perhaps a few minutes) while the quote is good. Then a potential customer can quickly try to solicit competing quotes from other market makers and execute the trade at the best bid or offer.

Trade Execution and Position Management

In order-driven markets, market makers compete to capture flow trading. By flow trading, we mean frequent execution of standard sized orders (round lots) submitted by ordinary traders and other market makers.

Bid-ask spreads are generally quite narrow, due to competition from other traders' orders and other market makers competing to capture the public order flow. This type of trading commonly occurs on stock exchanges, futures exchanges and options exchanges worldwide.

In quote-driven markets, orders come to a market maker sporadically. Some trading activity is like flow trading, as customers quickly hit quotes for standard sized trades (usually around $1 million minimum) of simple instruments like foreign exchange, or FX, contracts or U.S. treasuries.

Other trades are tailored deals that have negotiated terms. Such trades may involve complex derivatives, large blocks of instruments like corporate bonds, swaps, foreign exchange, repos or forward delivery of physical commodities.

For large trades, a market maker usually tries to assemble a position to prehedge a customer's pending buy order, or to find another buyer for the position in a customer's pending sell order, before the initial customer's trade is executed. An OTC market maker therefore tries to set up both sides of a large or complex order before either side of the trade is executed.

Although this might appear to be like front-running a booked limit order in an order driven market, it is a normal and customary risk management practice in a quote-driven OTC block market.

Market Making in Perspective

In a series of recent prosecutions, the government has implied that a market maker in a quote-driven OTC market should be able to provide the same execution profile for a bespoke block trade as that which occurs for a small round lot trade in an order-driven market.

At the same time, the government has asserted that a block trader's obligation to its customer is like that of an underwriter in a secondary offering. This hypothetical combination of market-making practices is based on several misapprehensions.

In a quote-driven market the market maker agrees to trade a specified quantity at a quoted price in a bilateral transaction. To do this, the market maker must acquire either orders or inventory in advance, at prices that gives it a chance for a profit on the transaction. Otherwise, the market maker would not transact.

Acquiring large blocks of orders or instruments to sell at a quoted price subjects the market maker to risk while holding the order or position, which must be managed. A market maker therefore prudently acquires orders or inventory and sets prices in a manner that allows itself to manage risk and try to avoid a capital loss. The result may be a price per unit for a large block trade that looks less favorable to the customer than the going price in a round lot order-driven parallel market.

We have observed competing views on market maker trade execution in four recent criminal prosecutions: Johnson (FX),[5] Bogucki (FX options),[6] Demos (residential mortgage backed securities, or RMBS)[7] and Litvak (RMBS)[8]. All four cases involved alleged dishonesty, front-running or a breach of duty to the market maker's counterparty.

In early March, Barclays trader Robert Bogucki was acquitted of lying to and trading against a potential counterparty in an FX options transaction. The court ruled that the government failed to prove that Bogucki or Barclays had a "duty of trust" to its customer, and acknowledged that prehedging is typical and permissible.

The court also recognized that Bogucki acted as a principal in this market, not an agent of his customers.

In fact, the court went so far as to state that the government fundamentally misunderstood the market, recognizing that risk hedging was common practice.[9]

Demos was similarly acquitted. In that matter, the court recognized that, even though Demos gave his customers unfavorable pricing terms, he was under no obligation to give them better terms. The court recognized the sparse trade nature of quote-driven markets, ruling that even if Demos gave his customers better terms, their behavior likely would remain the same.[10]

In the Litvak matter, a case in which jury convictions were twice reversed, the Second Circuit Court of Appeals rejected the argument that Litvak exploited a "relationship of trust" with his customers, recognizing again that an OTC market maker is not bound by a fiduciary duty.[11] These cases illustrate that OTC market makers do not generally have an obligation to give their customers favorable terms.

In contrast, in April 2018, Mark Johnson was convicted of front-running an FX transaction at the daily "fix" price for a client.[12] The government argued that he had a fiduciary-equivalent duty to his customer (despite the trading contact's terms). The Johnson matter is under appeal, and the recent outcome in the Bogucki trial could play a role in the appellate court's finding — though clearly the fact set is different.

Northwestern University professor Torben Anderson also filed an amicus brief to the appellate court on Johnson's behalf, explaining that "by branding pre-hedging as improper front-running, the Government threatens to effectively criminalize a routine practice that benefits customers."[13]

Conclusion

The outcomes of the Bogucki, Demos and Litvak matters — and potentially Johnson, depending on the appellate decision — point to a consistent view of market-making behavior in quote-driven markets.

While the facts differ in every case, actions in these OTC markets that may appear to be front-running or unfair pricing often stem from the need to for a market maker to hedge a position, haggle to arrive at a price and compensate itself for its capital commitment and assumption of risk.

If dealers are forced to adapt to an alternative view of how quote-driven markets makers should operate, those OTC markets likely will suffer from decreased immediacy and liquidity, as dealers are less inclined to participate. Moreover, the same activities at issue in recent cases in the FX and RMBS markets are widespread in other lightly regulated OTC markets, like those for U.S. treasuries, swaps, repos and structured products.

A balanced view based on an understanding of what makes these markets operate efficiently provides the right perspective on the ultimate market outcomes.

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[1] See, e.g., U.S. v. Mark Johnson and Stuart Scott, 1:16-cr-00457-NGG (U.S. District Court, Eastern District of New York; U.S. v. Robert Bogucki, 5:18-cr-00021-EJD (U.S. District Court, Northern District of California); U.S. v. David Demos, 3:16-cr-00220-AWT (U.S. District Court, District of Connecticut); U.S. v. Jesse Litvak, 808 F.3d 160, 165 (2d Cir. 2015).

[2] In an order matching process, market makers do not participate in the trade. Rather, customer buy and sell orders are crossed when the price and quantity offered by one matches the price and quantity bid by another.

[3] A fiduciary's duty is to act in the best interest of its customer. In a conventional market maker's contract with its counterparty, no such duty is imputed to the market maker.

[4] In fixed price underwritten transactions, the underwriter generally tries to presell an issue through an informal order solicitation process. In this process, the underwriter asks potential buyers for orders, and "circles" those orders that are confirmed (informally) at the public offer price. Some customers may agree to buy an issue at the circle price only if the underwriter agrees to buy a different security back (swap) from the customer, perhaps at a slightly preferential price. Thus, although underwritten issues are supposed to be sold only with a prospectus, and all sales are supposed to be at the public offer price, the process really works quite differently.

[5] U.S. v. Mark Johnson and Stuart Scott.

[6] U.S. v. Robert Bogucki.

[7] U.S. v. David Demos.

[8] U.S. v. Jesse Litvak.

[9] Godoy, Jody, "Ex-Barclays Trader's Sudden Acquittal Sends Shock Waves," Law360, March 5, 2019.

[10] Dolmetsch, Chris, "Ex-Cantor Fitzgerald Trader Not Guilty in Bond Fraud Case," Bloomberg News, May 3, 2018.

[11] Kim, Joon, et al., "2 Strikes And You're Out: The Litvak Saga Comes To An End," Law360, Aug. 8, 2018.

[12] Newman, Andrew, Oldfield, and Hinton, "The Johnson Conviction and Fallout for Forex Market," Law360, Dec. 8, 2017.

[13] U.S. v. Mark Johnson, Brief for Amicus Curiae Finance Professor Torben G. Andersen in Support of Defendant-Appellant and Urging Reversal, Case No. 18-1503, United States Court of Appeals for the Second Circuit.