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January 2013

LIBOR Manipulation

The implications for all financial institutions

Executive Summary

Our previous note (accessible here: LIBOR Manipulation bulletin-August 2012) described the ongoing LIBOR scandal being a "fast-developing topic". The past few months have certainly not disappointed on that front. In this note, we consider the impact of recent developments in the English Courts, the implications of the various investigations into LIBOR manipulation by UBS and, finally, the challenges faced by financial institutions in assessing loss and damage resulting from LIBOR manipulation.

Developments in the English Courts - Graiseley Properties Limited and Others v Barclays Bank Plc[1] ("Graiseley")

This case has attracted considerable media interest. Widely seen as being the first English LIBOR test case (indeed, that was part of the rationale for it being transferred from the Birmingham Mercantile Court to London Commercial Court), the case involves a claim against Barclays Bank in relation to a series of derivative products that were linked to 3-month sterling LIBOR.

In October 2012, in light of the FSA's Notice against Barclays, a hearing took place in which the Claimants sought permission to amend their Particulars of Claim. The Claimants wanted to plead that various implied representations were made on the part of Barclays and certain implied terms applied (i.e. that LIBOR was not to be manipulated), that were relied on by the Claimants in entering into the LIBOR-linked products. Part of the hearing also related to the parameters for disclosure to be provided by Barclays (such as the individual custodians whose records were to be searched, and the time periods for such searches).

Following a highly-charged hearing, which spanned several days, Mr Justice Flaux was unequivocal in his support of the Claimants' position – "*It seems perfectly obvious... that the people responsible for giving those instructions* [to manipulate LIBOR] *must have known customers were being misled*" – and granted permission for the amendments to be included. Reasonably wide-reaching disclosure parameters were also laid down, by reference to various individuals whose documents had been searched as part of the FSA's initial investigation.

The trial in the Commercial Court is expected to take place in October this year, and to last for between 25-30 days. However, given the importance of the case to both sides, it would not be a surprise to see numerous further interlocutory skirmishes between now and then. It was also reported recently that a similar case has commenced in the English Courts involving Deutsche Bank AG[2], where, as with *Graiseley*, permission is being sought to amend pleadings so as to include various LIBOR-related points.

[1] [2012] EWHC 3093
[2] Deutsche Bank AG v Unitech Limited, High Court of Justice, Queen's Bench Division

UBS AG

On 19 December 2012 the UK's Financial Services Authority ("FSA") published its findings in relation to UBS. The main headline was the record £160 million fine imposed on UBS (albeit the FSA confirmed that a £200 million fine would have been imposed had UBS not agreed to settle at an early stage, thereby triggering a 20 per cent. reduction in the fine). This dwarfed the £59.5 million fine imposed on Barclays (which was subject to a 30 per cent. early settlement reduction). The FSA made clear that the reason for the increased fine was because "*UBS's misconduct [was] considerably more serious than Barclays' because it was more widespread within the firm, being exacerbated by the control failings...*" On the same date, UBS disclosed that it has been fined a total of US$1.2 billion by the Department of Justice and the Commodity Futures Trading Commission in the US and CHF59 million by the Swiss Financial Market Supervisory Authority.

The FSA found that in the 5 years between January 2005 and December 2010 nearly 1,000 internal requests were made for submissions that would benefit UBS' trading positions. A similar number of requests were made to 11 interdealer brokers – one trader going so far so as to suggest false bids be made so as to skew market perceptions favourably. Another UBS trader colluded with individuals at other panel banks in a bid to influence JPY LIBOR submissions and (entirely corrupt) payments were made to reward brokers for their co-operation. The FSA described "*a culture where the manipulation of LIBOR and EURIBOR setting process was pervasive. The manipulation was conducted openly and was considered to be a normal and acceptable practice by a large pool of individuals*". Tom Hayes, a former UBS trader, was arrested in December 2012 following a Serious Fraud Office investigation. In this context, it is notable that, according to the Wheatley Report (referred to below) JPY LIBOR is used as the reference rate in some 27 per cent. of all interest rate swaps and floating rate notes, with 6 month JPY LIBOR referenced in some 23.5 per cent. of such transactions.

How do the above developments impact upon a potential claim?

The decision in *Graiseley* clearly paves the way for existing claims to be amended, and for new claims to be pleaded on a broader basis than they previously might have been, with potential claimants having some comfort from the decision in *Graiseley* that the defendant bank is likely to face an uphill struggle should it seek to strike out certain elements of the claim. From a disclosure perspective, *Graiseley* would also suggest that there is little traction in the banks arguing that the disclosure they have previously provided to regulators does not fall to be disclosed.

The FSA's findings in relation to UBS – specifically, the collusion between various brokers and (potentially) other submitting banks - would potentially make an unlawful act conspiracy claim available thereby increasing the list of potential defendants, albeit that such a claim would, on the face of it, appear to be confined to claims in relation to the JPY LIBOR at present.

Despite the increased fine it received, it does appear that attributing knowledge of the practice to the top-level executives at UBS may be more difficult than with Barclays, where Bob Diamond (former Chief Executive) and Jerry Del Missier (former Chief Operating Officer) were both found to have had a knowledge of the attempted manipulation. Nonetheless, the FSA's scathing comments regarding a "*culture of manipulation*" and the sheer volume of lower level employees being aware of and/or involved in the practice may well provide an alternative route to the same conclusion.

Assessing loss and damage resulting from LIBOR manipulation

A report commissioned by the UK government and published in September 2012 *(The Wheatley Review of LIBOR)* estimated the size of the LIBOR-benchmarked market globally as being in the region of US$300 trillion – as shown in Table 1.

Table 1 - Use of LIBOR in Financial Contracts

Instrument/Application	Estimated value of contracts with LIBOR as benchmark
Syndicated Loans	~$10 trillion[a]
Floating Rate Notes	~$3 trillion[b]
Interest Rate Swaps	$165[c] – $230 trillion[d]
Exchange-traded Interest Rate Futures and Options	$30 trillion[d]
Forward Rate Agreements	$25(d) – $30 trillion[e]
Total	~$300 trillion

Note: Assumption that 50 per cent of contracts reference LIBOR; this list is not exhaustive.

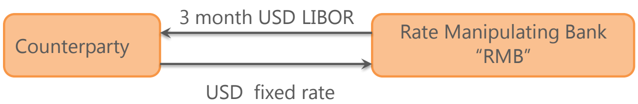
Sources: (a) Oliver Wyman; (b) Dealogic; (c) DTCC; (d) Bank for International Settlements; (e) Trioptima

By far the largest section of this market is made up of interest rate swaps. Other classes of financial contract, that might be said to have greater market transparency (such as syndicated loans and floating rate securities), are of far lesser order of magnitude. The cashflows in a typical "plain vanilla" interest rate swap are shown in Table 2 below.

Table 2 demonstrates the way in which LIBOR manipulation, on any rate reset date within the interest rate swap, can serve to decrease the amount payable to the counterparty by a variable amount – depending on the notional amount of the swap and the extent of the effectiveness of the manipulation. There may be a reverse effect where LIBOR is manipulated upwards and in transactions where the counterparty to the Rate Manipulating Bank is the floating rate *payer*.

Moreover, the effect of successful manipulation can be magnified to a very large extent in cases where a trigger mechanism is included in the swap or other derivative. For example, in Table 2, the effect of LIBOR manipulation may be perpetuated throughout the term of the contract if LIBOR falls below, or rises above, a pre-determined level, which (pursuant to the relevant contract) crystallises a different set of cashflows throughout the remainder of the term.

Table 2 – plain vanilla interest rate derivative – a hypothetical interest rate swap



<u>Terms</u>:
- Date of agreement: 1 January 2005; Governing law: [English/US]
- Notional: USD 1bn
- No trigger or other non-standard terms

<u>Assume</u>
Rate Manipulating Bank succeeds in reducing 3 month USD LIBOR by 10 basis points on the first reset date in Year 1 (i.e. 1 April 2005)

<u>Impact on cashflows</u>
RMB's payment obligation is reduced by 0.1% pa for 3 months. This amounts to USD 1.0m x ¼ = USD 250,000. The same principle applies on each occasion that LIBOR is reduced by manipulation.

LIBOR manipulation will have affected a wide range of institutions, whether they were counterparties to interest rate swaps during the relevant period or otherwise exposed to LIBOR movements through holdings of floating rate securities (which would include most securitisations, CDOs, credit-linked notes, etc.) or other types of derivatives, or as lenders or borrowers under loan agreements. One starting point for such institutions in the process of determining whether LIBOR manipulation may have caused them loss, would be to map, over a period from January 2005 to the end of December 2010, particular dates on which payment flows on those assets and liabilities would have been particularly sensitive to the relevant LIBOR setting.

Then a more detailed analysis may be required to determine whether evidence exists that LIBOR may have been manipulated on such particularly sensitive dates. A number of published statistical studies have demonstrated instances where LIBOR fixings for certain currencies and maturities have diverged from what other market indicators would have suggested. Commentators have proposed various methods that might be used to more accurately determine the true cost of borrowing for any given rate-submitting bank that its LIBOR submission was intended to represent – such as investigating actual interest rates paid on short term Certificates of Deposit or Commercial Paper issued by that bank at or around the particular dates under investigation.

All of this may lead to a greater or lesser inference that one or more banks may have succeeded in manipulating LIBOR on particular occasions.

The next challenge will be to find actual evidence of manipulation, which will require not only proof of the attempt to manipulate, but also evidence that such attempt was successful. In this regard it is notable that the investigation by the Swiss financial regulator into UBS resulted in a penalty requiring UBS to "disgorge estimated profits to the Swiss Confederation amounting to CHF59 million". There must surely be a recognition in this that UBS had been successful in its attempts to manipulate LIBOR.

The above analysis relates specifically to contracts between a bank that is found to have manipulated LIBOR and its own counterparties. There is likely to be a far greater community of derivative counterparties and other market participants who have suffered a diminution in income or increase in outgoings as a result of LIBOR manipulation carried out by a LIBOR panel bank that is not on the other side of the relevant transaction. In such cases, where no contractual relationship exists, potential claimants may have to rely on any tortious remedies available to it under English law.

This note has been created by affiliated partners Enyo Law and David Doble Solicitors. The Enyo Law team consisted of Marcus Rutherford, Edward Allen and Max Hotham.

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