

MICHAEL O’HIGGINS FX CLASS REPRESENTATIVE LIMITED

HOW DAMAGES FROM THE FX CARTELS WILL BE QUANTIFIED

1. Introduction

Michael O’Higgins FX Class Representative Limited (the *O’Higgins PCR*) is leading a legal action in the UK against five banks that have been fined €1.087 billion by the European Commission for anticompetitive conduct in the FX market between 2007 and 2013. This legal action is what is called a ‘competition damages action’ in that it seeks to return hundreds of millions of pounds in damages to pension funds, asset managers, hedge funds and corporates from around the world (the *Class*) who were affected by the anticompetitive conduct.

In this article we discuss how damages are generally quantified in competition damages actions and how, given the unique features of the FX market, the O’Higgins PCR proposes to quantify the damages specifically owed to the Class in this action. The article concludes by explaining how Class members can obtain further information on the O’Higgins PCR’s action generally and in relation to the quantification of damages specifically.

2. How to Quantify Competition Damages Generally

In a competition damages action you seek to establish the ‘counterfactual’, which is the hypothetical situation that would have existed had the anticompetitive conduct not taken place. There are a number of steps to determine the counterfactual which are described in turn below for a cartel scenario.

Value of commerce

First, you begin by calculating the total amount paid by the claimants (such as the Class in this case) to the cartelists for the cartelised product or service during the period when prices were affected by the cartel. This total is referred to as the ‘value of commerce’.

But-for price

Second, you seek to determine the prices that the claimants would have paid in the ‘counterfactual’ world in which there was no anticompetitive conduct. These prices are often referred to as the ‘but-for’ prices, as they are the prices that the claimants would have been paid ‘but-for’ the anticompetitive conduct. There are a number of well-established techniques in the field of competition economics for estimating the but-for price. The techniques likely to be used in the FX case are outlined below.

Overcharge

Third, you compare the actual prices paid for the cartelised product or service with the but-for prices. The difference between the actual prices paid by the claimants and the ‘but for’ prices is referred to as the ‘overcharge’. In competition damages actions the overcharge is often expressed in percentage points as a rate with respect to the prices paid by the claimants.

Overall claim value

The overcharge rate is then applied to the value of commerce figure, which will provide a base level of damages which can be adjusted to reflect the particular circumstances of the case. Case-specific features of the quantification of damages may include interest, ‘pass-on’, and tax. Of these, the

application of interest will increase the base level of damages while accounting for pass-on and tax may reduce the base level. Taking these in turn:

- Interest should be awarded to reflect the passage of time since the anticompetitive conduct took place, which is often many years before any award of damages or settlement. The applicable rate of interest and whether it should be applied on a simple or compound basis will vary depending on the case. However, the basic principle is that interest should be awarded to compensate the claimant and to reflect the amount the claimant has lost as a result of being out of pocket due to the anticompetitive conduct.
- ‘Pass-on’ is a concept which is also applied to reflect the actual amount lost by the claimant due to the anticompetitive conduct. Pass-on refers to the amount of the overcharge that was passed on by the claimant to the claimant’s own customers, particularly where the claimant set their price by reference to input costs that include the cost of the cartelised product or service. Under English law, if the claimant passed the overcharge further downstream, they are not the one who suffered loss and so they do not have a right to claim. It is for the defendants to prove that any pass-on took place although there is a burden on claimants to show how they address the recovery of costs in their business. The existence of pass-on – and if it exists, rate of pass-on – will always be a fact-specific question to each case.
- Deductions to the base level of damages may also be applied to reflect the claimants’ tax position.

The principles of how damages are quantified in general apply equally to individual actions and to collective actions like the O’Higgins PCR’s claim. In a collective action, you can have an ‘aggregate award of damages’ which the Competition Appeal Tribunal defines in Rule 73(2) of its rules as “*an award of damages made by the Tribunal in collective proceedings without undertaking an assessment of the amount of damages recoverable in respect of each represented person*”. How the aggregate award of damages will be calculated by the O’Higgins PCR in relation to the FX cartels is described in the following section.

3. How the O’Higgins PCR Will Quantify Damages Arising from the FX Cartels

To quantify damages arising from the FX cartels, the O’Higgins PCR has instructed two eminent experts:

- **Professor Francis Breedon:** Professor Breedon is Professor of Economics and Finance at Queen Mary University of London. His research focusses on the FX market including market microstructure (the study of how financial markets operate) and trading. He also has extensive industry experience as a consultant. Professor Breedon is supported by a team from the consultancy, BDO, consisting of members of their competition economics, financial services, and tax departments.
- **Professor B. Douglas Bernheim:** Professor Bernheim is the Edward Ames Edmonds Professor of Economics and the Trione Chair of the Department of Economics at Stanford University. His research focusses on a variety of fields including antitrust economics,

behavioural economics, game theory, and financial economics. Professor Bernheim is also a deeply experienced testifying expert in litigation. He is a Partner at the consultancy, Bates White, LLC (*Bates White*), and is supported by a team of experts from Bates White.

- **Industry Expert:** Professors Breedon and Bernheim are also assisted by a former FX trader, Mr Reto Feller of Velador Associates, in relation to understanding the market and how it operates.

Following the process described in the preceding section, the O'Higgins PCR's expert team will compute a base level of damages by calculating the total value of commerce affected, and estimating the overcharge rate caused by the FX cartels. The O'Higgins PCR's expert team will then determine the appropriate level and method of interest to be applied to the base damages and whether any adjustments should be made to account for pass-on or tax. Once any relevant adjustments have been made and interest has been applied, we will then have an aggregate damages figure for the Class.

4. How the Methodology Will Be Implemented in the FX Action

In competition damages actions in the financial services context, such as the O'Higgins PCR's action, there are some nuances to the general approach described in Section 2 above. This is because the products transacted in the financial services sector are not traditional goods (often referred to as 'widgets' by competition lawyers and economists) which customers buy at prices denominated in their domestic currency.

Specifically, the FX market is characterised by the following features:

- First, in relation to FX, the price for a unit of the product (i.e. a specific foreign currency) may be expressed in units of another, non-domestic, currency that one wishes to exchange for it (e.g., 1.22 US dollars for 1 euro). This price is referred to as the 'exchange rate'.
- Second, FX customers may buy the product as well as sell the product.
- Third, buy and sell transactions in the FX market are facilitated by 'market maker' banks who provide the market with liquidity by offering to buy the product (i.e. the foreign currency) at a 'bid' or sell it at an 'ask'.
- Market makers therefore provide a liquidity-providing service on top of the market for the product. The price of this market-making service is the difference between the bid and the ask which is referred to as the 'spread'.

In light of the above characteristics, one of the objectives of the cartelists in the FX cartels was to increase the price they receive for their market-making services by widening the bid-ask spread, without necessarily changing the mid-point between the bid and the ask. Accordingly, it is the spread which has to be measured to determine the relevant overcharge rate for calculating the quantum of damages suffered by the Class.

In quantifying the overcharge on the spread experienced by the Class, our expert team proposes to use two measures of the spread – 'realised spread' and 'effective spread' – which are supported by the market microstructure literature and are consistent with the principles of antitrust economics:

- **Realised spread:** The realised spread methodology measures the difference between the execution price of a buy or sell order and the ‘market-mid’ (the average of the bid and the ask) at a time after a trade’s execution;
- **Effective spread:** The effective spread methodology measures the difference between the execution price of a buy or a sell order and the ‘market-mid’ at precisely the same time.

The advantage of using realised spread is that it captures not only the widening of the bid-ask spread, but also the effect of the FX cartels’ direct manipulations of the exchange rates, for example at the time of benchmark fixing. In contrast, effective spread captures only the widening of the bid-ask spread. The difference between the overcharges given by these two spread measures will reflect the effect of exchange rate manipulations. To determine the overcharge for each spread measure, the O’Higgins PCR’s expert team will use a form of statistical analysis referred to as ‘regression analysis’. Regression analysis is a standard and accepted tool for measuring overcharges arising from anticompetitive conduct.

Regression analysis permits economists to study the relationship between a variable measuring an outcome of interest (a ‘dependent variable’), such as a price, and factors that influence the outcome (‘explanatory variables’), such as supply and demand conditions. Determining the exact set of the explanatory variables that need to be accounted for in a regression analysis will be a matter for our experts to consider carefully with respect to the FX market.

The regression analysis will then provide a figure or percentage rate for the overcharge arising from the FX cartels. From this point on, the analysis follows the general approach for quantifying cartel damages as discussed in Section 2 above. That is, the calculated overcharge figure or rate will be applied to the total volume of commerce by the Class (the value of commerce will be calculated using available data sources such as from the Bank of International Settlement’s triennial FX surveys). Applying the overcharge to the value of commerce will provide a base damages figure which may be adjusted to account for tax and pass-on. The total damages figure will be calculated by applying interest to the damages.

5. Estimated Damages and How Class Members Are Compensated

It is currently estimated that the total damages owed to the Class will amount to hundreds of millions or possibly billions of pounds. However, it is important to note that recovery of any money by way of the action is not guaranteed. The O’Higgins PCR must first be granted a collective proceedings order permitting it to continue as a collective action and will then need to prove its case at trial, unless the defendant banks settle the claim prior to trial.

If the relevant court, which is the Competition Appeal Tribunal, finds that an aggregate award of damages should be made, the damages for each individual class member will be computed by the claims administrator instructed by the O’Higgins PCR. If you are a member of the class, you should keep all records of your foreign exchange trades entered into between 18 December 2007 and 31 January 2013, and any other documents which you think may be relevant.

The legal process is likely to take several years. We encourage class members to register on the O’Higgins PCR’s website so that they will be sent occasional emails keeping them up to date of developments.

6. Conclusion

The O'Higgins PCR's team would be very happy to answer any questions from Class members on how damages will be quantified. To ask any such questions, or request to see the O'Higgins PCR's expert reports, please email info@ukfxcartelclaim.com.

Separately, updates on the progress of the O'Higgins FX Claim will continue to appear on the claim website <https://ukfxcartelclaim.com> and will be emailed to everyone who registers on the claim website at <https://ukfxcartelclaim.com/Request>.
