UNITED STATES OF AMERICA

BEFORE THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

WASHINGTON, D.C.

In the Matter of GUILLAUME HENRI ANDRE FONKENELL A Former Institution-Affiliated Party of Bankers Trust Company, New York, New York	)	Docket No. 98-032-B-I 98-032-CMP-I

FINAL DECISION

This is an administrative proceeding of the Board of Governors of the Federal Reserve System (the "Board"), based upon the issuance on October 29, 1998, of a "Notice of Charges and of Hearing and Notice of the Assessment of a Civil Money Penalty Issued Pursuant to Sections 8(b) and (i) of the Federal Deposit Insurance Act, as Amended" (the "Notice"). The Notice alleges that respondent Guillaume Henri Andre Fonkenell, a former derivatives trader at Bankers Trust Company, New York, New York, violated the law and engaged in unsafe or unsound practices in connection with two leveraged derivative trades in which he was involved. The Notice, as amended, seeks a civil money penalty of $250,000 and a cease and desist order prohibiting Fonkenell from serving as an institution-affiliated party of any financial institution where his duties include participating in structuring derivative transactions for sale or marketing to customers, advising customers regarding the purchase, sale, or structuring of a derivative transaction, and preparing marketing materials regarding derivatives transactions.[1]

Following an extensive hearing and submission of post-hearing filings, administrative law judge Walter J. Alprin (the "ALJ") issued a Recommended Decision ("RD") recommending that the Board find that the allegations in the Notice are not supported by the record, and that the Board dismiss the Notice in its entirety. Enforcement Counsel filed exceptions to the RD, in which they argued that while the ALJ's factual findings were correct, they did not include certain facts supported by the record. Enforcement Counsel also excepted to the ALJ's conclusions of law. Fonkenell's exception was limited to his contention that the ALJ erred in permitting the testimony of Enforcement Counsel's expert witness.[2]

Upon review of the administrative record, the Board hereby makes its Final Decision and adopts the ALJ's Recommended Decision, Recommended Findings of Fact, and Recommended Conclusions of Law, except as specifically supplemented or modified herein. The Board therefore determines that no enforcement order is warranted under the facts of this case, and dismisses the Notice.

STATUTORY OVERVIEW

The Federal Deposit Insurance Act (the "FDI Act") provides that the appropriate Federal banking agency may issue a cease and desist notice against a

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[1] The original Notice sought in addition a cease and desist order precluding Fonkenell's service as an institution-affiliated party at any financial institution or agency identified in 12 U.S.C. § 1818(e)(7)(a) without Federal Reserve approval. On May 7, 1999, the Board amended the notice to delete that requested relief and to substitute a request that the Board order "other appropriate restrictions on [Fonkenell's] future activities as an institution-affiliated party as are warranted based on the record in this proceeding."

[2] This issue is not properly an exception, as the ALJ did not make any findings based on the expert's challenged testimony. Accordingly, the Board takes no position on the propriety of the admission of this testimony.

depository institution or an institution-affiliated party within its jurisdiction if it has reasonable cause to believe that the institution or party has engaged in an unsafe or unsound practice, or has violated a law, rule, regulation, or certain conditions imposed in writing. 12 U.S.C. § 1818(b)(1). Following issuance of a Notice, the Board's Rules of Practice assign responsibility to an ALJ to hear the matter and make a recommended decision to the Board. 12 C.F.R. § 263.5. The parties may file exceptions to the ALJ's recommended decision, and the Board makes final findings of fact and conclusions of law, and determines whether to issue a cease and desist order. 12 C.F.R. § 263.40.

A cease and desist order may be issued if the agency finds on review of the record "that any violation or unsafe or unsound practice specified in the notice of charges has been established." In that event, the Board may issue an order requiring the respondent to cease and desist from the practice, and "to take affirmative action to correct the conditions resulting from any such violation or practice." 12 U.S.C. § 1818(b)(1). This authority includes the authority, among other things, to require the respondent to "take such other action as the banking agency determines to be appropriate" (12 U.S.C. § 1818(b)(6)(F)) and the authority to "place limitations on the activities or functions of . . . any institution-affiliated party." 12 U.S.C. § 1818(b)(7).

The appropriate Federal banking agency may assess a civil money penalty at various levels under various conditions set forth in the statute. A "first tier" civil money penalty of $5000 per day may be assessed against any institution-affiliated party who violates a law, regulation, final order, condition imposed in writing, or written agreement with the agency. 12 U.S.C. § 1818(i)(2)(A). A "second-tier" civil money penalty of $25,000 per day may be assessed against an institution-affiliated party who commits any of the above violations, or who "recklessly engages in an unsafe or unsound practice in conducting the affairs" of the institution, or who breaches a fiduciary duty, if the Board makes the additional finding that the violation, practice, or breach was either part of a pattern of misconduct, or caused (or was likely to cause) more than a minimal loss to the institution, or resulted in pecuniary gain or other benefit to the respondent. 12 U.S.C. § 1818(i)(2)(B).

As with a cease and desist proceeding, the respondent has a right to a hearing before an ALJ, and the Board makes the final decision regarding the imposition of a penalty. 12 C.F.R. § 263.40.

An ALJ's findings of fact are not conclusive on the agency. Under the Administrative Procedure Act, it is the agency, not the ALJ, that has the responsibility for making findings of fact based on the record, and drawing legal conclusions from them. Greater Boston Television Corp. v. FCC, 444 F.2d 841, 853 (D.C. Cir. 1970), cert. denied, 403 U.S. 923 (1971). Nonetheless, because the ALJ has had an opportunity to hear the evidence directly and assess the credibility of witnesses, agencies generally defer an ALJ's credibility assessment unless the evidence clearly warrants rejection of that assessment. See, e.g., Stanley v. Board of Governors, 940 F.2d 267, 272 (7th Cir. 1991).

DISCUSSION

The facts of this case revolve around two separate sets of transactions, the "Indonesian Transactions" and the "Procter & Gamble [or P&G] Transaction." Both were leveraged derivative transactions sold by Bankers Trust to clients, and in both cases Fonkenell was involved in his capacity as a trader on Bankers Trust's dollar derivatives desk. In both cases, Enforcement Counsel contends that Fonkenell's actions constituted an unsafe or unsound practice justifying imposition of the civil money penalty and cease-and-desist relief sought.[3] Apart from these similarities, the facts of the two transactions do not overlap, and the Board, like the ALJ, will consider them separately.

A. THE INDONESIAN TRANSACTIONS

A derivative is a financial product the value of which is based on, or derived from, something other than the transaction itself. During the late 1980s and through the mid-1990s, the market for derivatives products increased substantially, and Bankers Trust was at the forefront of this expansion. Among the Bankers Trust employees involved in the derivatives trade were marketers, who presented transactions to clients, and traders, who developed and structured derivatives transactions, priced the transactions, and hedged the risk associated with the transactions. Generally, traders had little or no contact with customers, and this was true for Fonkenell in connection with the Indonesian transactions.

In 1993 and 1994, Fonkenell was a trader in Bankers Trust's "dollar derivatives" desk, responsible for several trading books and also for developing derivatives transactions for marketers. Fonkenell was located in Bankers Trust's offices in New York. One of the marketers with whom Fonkenell interacted was Hogi Hyun, a well-regarded managing director of Bankers Trust based in Southeast Asia.

As part of his job developing potential transactions for marketers, on January 18, 1994, Fonkenell sent an electronic mail message to Hyun and others,

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[3] Enforcement Counsel originally contended that Fonkenell's involvement in the Indonesian transactions constituted wire fraud in violation of 18 U.S.C. § 1343, and that his actions in connection with the P&G transaction resulted in a false entry in the books and records of a financial institution in violation of 18 U.S.C. § 1005. The ALJ rejected these claims in the Recommended Decision, and in its post-decision filings Enforcement Counsel did not except to the ALJ's conclusions. Enforcement Counsel also has not argued that Fonkenell's actions constituted a breach of any fiduciary duty.

proposing a so-called “barrier swap” trade for “one of the PT’s,” a term for Indonesian corporations. Board Ex. 18. Under this type of trade, Bankers Trust would pay the customer a fixed rate on the principal (or “notional”) amount to maturity, and the customer would make payments to Bankers Trust calculated by applying an agreed-upon formula to the notional amount. The formula proposed in the January 18 message was that the customer would make payments to Bankers Trust based on the “12-month late LIBOR rate” plus a specified “spread,” which would in turn be calculated based on the movement of interest rates in the market.[4] If the 6-month LIBOR rate never traded above 4.75 percent during the first year of the contract, the spread would be zero (and the customer would pay just the 12-month late LIBOR rate). If that interest rate “barrier” were breached within the first year after the trade, the customer would pay in addition a spread equal to ten times the difference between the six-month LIBOR rate and 3.75 percent. The spread formulation in the January 18 message was expressed as “10 x [6mLIB – 3.75%].” Because the customer would pay ten times the difference in the rates, the leverage factor in the formula was 10.

Fonkenell and Hyun subsequently spoke about the proposal. Hyun indicated that he liked the idea, but that he wanted to “hide the leverage” in the trade. Fonkenell discussed the proposed trade and Hyun’s request to hide the leverage with Oliver Lu, a trader assisting Hyun, on January 19 and again on January 24, 1994. In each of these tape-recorded conversations Fonkenell and Lu discussed various methods of

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[4] “LIBOR” refers to the London Inter Bank Offered Rate, a set of interest rates published daily and widely used in such instruments.

reformulating the spread in order to "hide the leverage" in the transaction.[5] Among the methods they discussed was the use of a divisor rather than a multiplier to express the leverage in the transaction. In neither of the taped conversations did Fonkenell or Lu discuss why Hyun would want to hide the leverage in the transaction. They did, however, discuss moving the interest rate "barrier" up to a figure higher than the 4.75 percent favored by Hyun. Raising the barrier would mean that the customer was less likely to have to pay the spread. Lu commented in this regard, "I don't want to be too greedy . . . I want to make sure the guy wins," to which Fonkenell replied, "yeah me too exactly. Yeah, we should, I was looking on what barrier, I was looking I think 5 %." Board Ex. 16A at 10.

After the second conversation with Lu, Fonkenell sent a second message to Hyun, stating that he had "thought about ways to hide the leverage and came up with the following." Board Ex. 19. The trade proposed in this second message differed in a number of respects from that shown in the January 18 message. The barrier was 5 percent, and the amount Bankers Trust paid to the customer on its side of the swap was calculated differently. But most importantly for purposes of this proceeding, the spread if the barrier were breached was expressed as follows:

$$\text{SPREAD} = (\text{6mLIBOR} / 4.3125\%) - 1.$$

In this formulation, the spread is calculated by dividing a rate (6-month LIBOR) by a percentage – 4.3125 percent. Dividing a number by 4.3125 percent is the mathematical equivalent of multiplying that number by approximately 23, making the leverage factor for this formula about 23.

[5] At Bankers Trust, as elsewhere, traders' telephone lines were recorded in order to provide confirmation of orders, and for other purposes.

In late January and February 1994, Hyun sent barrier swap proposals based loosely on the proposal set forth in Fonkenell's second message to two Indonesian customers. Board Ex. 20, 21. In both cases, the spread if the barrier was breached was expressed as the 6-month LIBOR rate divided by a percentage (4.3 percent in one case, 4.5 percent in the other), minus one. In one case, the barrier under which the spread would be zero was 5 percent, and in the other it was 5.25 percent. In each case, the proposal informed the customer that "as the likelihood of 6-month USD LIBOR trading above [the barrier] is very small," the customer was likely to enjoy a low cost of funds under the proposal. The proposals were also accompanied by discussions of the U.S. economic outlook which projected the 6-month LIBOR rate to be well below the barrier by year-end 1994 (the time when the barrier would be tested), and a "sensitivity analysis" that failed to show clearly the effect of the transaction at higher interest rate levels. It is undisputed that Fonkenell had no responsibility for or input into the marketing material presented to these customers.

Interest rates rose dramatically in 1994, and these trades resulted in substantial losses to the Indonesian customers. Both customers complained about the trades, and in particular the sales practices used to market them. Both transactions ended up in court, where the disputes were ultimately settled by the parties.

On the basis of these facts, Enforcement Counsel asserts that Fonkenell engaged in an unsafe or unsound practice in that he "intended to deceive" the Indonesian customers by providing a formula to "hide the leverage." On this record, the Board cannot agree. The record contains no evidence that any customer was defrauded or misled by *the spread formula itself*, which is the only part of the transaction in which

Fonkenell had a role. Indeed, there is no evidence that any customer was defrauded at all. The fact that Bankers Trust entered into a settlement with customers, with a disclaimer of wrongdoing, cannot be considered evidence of fraud.[6] Commercial enterprises settle claims for a variety of reasons, some of which have nothing to do with the merits. Moreover, even if there were legitimate liability on the part of Bankers Trust, on this record it is more reasonable to assume that it stemmed from the marketing materials – which were outside of Fonkenell's responsibility or control – than from the spread formula itself, which admittedly accurately set out the terms of the transaction.

It is important in this regard to put Fonkenell's actions in context. At that time at Bankers Trust, the use of formulas in which the leverage factor was expressed as a divisor was commonplace. Use of such a formula violated no rule, regulation, or policy of the Federal Reserve or any other regulator – indeed, there still is no prohibition or limitation on the use of divisors to express leverage. Thus, the only basis for Enforcement Counsel's claim that Fonkenell's actions constituted an unsafe or unsound practice is that Fonkenell created the formula in order to respond to a request to "hide the leverage," and Enforcement Counsel's assertion that Fonkenell intended that the formula he developed would in fact "hide the leverage" from – and thus defraud – Bankers Trust customers.

While the use of the phrase "hide the leverage" certainly raises concerns, in the context of this type of transaction the concerns do not appear to be well-founded. A formula that accurately states the leverage factor cannot by itself be misleading. The

[6] In fact, as the ALJ pointed out, there is no evidence that the amounts paid to the customers by Bankers Trust under these settlements even exceeded the amounts it was obligated to pay under the terms of the swap transactions. RD at 34.

leverage factor might be more obvious to some customers when expressed as a multiplier rather than as a divisor, but the mathematical result is the same. It is undisputed that Fonkenell did not know the identity of any particular customer to whom the barrier trade might be marketed, so he had no basis on which to presume greater or lesser mathematical sophistication on the part of the customer. Fonkenell explained that he understood the purpose of "hiding the leverage" to be to permit a marketer to discuss a complex transaction with a potential customer in a way that would allow full consideration of the transaction's risks and rewards, rather than focusing on the leverage factor which was only one component of risk. Fonkenell was aware that a sensitivity analysis would normally be provided to customers showing a wide range of outcomes of the trade, both positive and negative, based on a wide range of possible rates in the market. Tr. at 1930. While such an analysis appears not to have been presented in connection with these particular trades, there is nothing in the record to suggest that Fonkenell had either any responsibility for that failing or even any basis to believe it would occur. In short, Fonkenell's use of the phrase "hide the leverage" is not enough to turn his otherwise legal actions into an unsafe or unsound practice.

B. THE PROCTER & GAMBLE TRANSACTION

1. Background

Fonkenell began his career at Bankers Trust in June 1990, as a junior swap trader. By November 1993, Fonkenell was a relatively senior trader in Bankers Trust's New York office. He was responsible for oversight of several options books – portfolios of common transactions linked to one or more particular market variables – although by late 1993 he no longer had day-to-day responsibility for any book. Among the books for which he had oversight responsibility was the so-called T24 book. A more junior colleague, Kassy Kabede, had day-to-day responsibility as the "book runner" for the T24 book. Fonkenell and Kabede reported to Ari Bergmann, who managed the dollar derivative desk as a whole.

At the end of October 1993, Kabede and Bankers Trust marketer Kevin Hudson were working on a major derivatives transaction with Procter & Gamble (the "P&G Trade"). The P&G Trade was an "exotic" trade involving an option linked to the value of Treasury instruments, and as such it would be recorded and managed principally on the T24 book for which Kebede was chiefly responsible. Kebede, however, was out of the country during the week beginning November 1, 1993, and in his absence Fonkenell filled in for him as book runner for the T24 book.

The P&G Trade was a "5s/30s swap", under which Bankers Trust would pay P&G a fixed rate for the six-year life of the transaction, and P&G would pay Bankers Trust a variable rate based on the future prices of the 5-year Treasury note and the 30-year Treasury bond, as determined six months after the trade date. With a notional amount of $200 million, the P&G Trade was one of the largest derivative transactions Bankers Trust had entered into.

At Bankers Trust, the trader's role in executing a trade like the P&G Trade involved a number of steps. The trader was involved with the marketer in pricing the trade. Following its execution, the trader was responsible for hedging the Bankers Trust's risks associated with the transaction. In addition, the trader was responsible for working with Bankers Trust's "back office" operation to book the transaction, including allocation of portions of the trade's expected profits among various trading books. The back office person responsible for booking the P&G Trade was Joseph Mancino.

The back office entered the trade into the bank's books, and marked the books to market every day by recalculating the value of the various trades in the book to take account of market changes in the various components of the transactions in the portfolio. One of the components of the trades in the T24 book was the "volatility" of the underlying instruments to which the trades were linked, including the 5-year Treasury Note and the 30-year Treasury Bond. Volatility is a measure of the degree of uncertainty of future price movements. When volatility goes up, the price of an option goes up. While there is a market for volatility, it is unlike other components of the trades in the T24 book, because the level at which volatility trades on a given day is not widely available. Instead, volatility is determined or derived from options that are traded in the market by using a model that calculates volatility based on an option's strike rate, time to expiration, discount rate, and other factors.

In the options market, volatility trades within a range, known as the "bid/ask spread." When pricing a trade or selecting an appropriate volatility figure at which to value the trade for booking purposes, a trader must take account of the fact that he will be hedging the risk of the trade by engaging in opposing transactions, and that his hedges will be executed at either the bid or the offer side of the market, depending on whether he is buying or selling volatility. The trader will therefore select a volatility number that is either on the bid or the ask side of the market when pricing a transaction. At Bankers Trust, the same factors were taken into consideration when providing a volatility figure to the back office for purposes of booking and valuing a transaction.

When a book such as the T24 book was long on volatility, as it was following the execution of the P&G Trade, the trader was expected to use a figure at the lower end of the bid/ask range when supplying volatility figures to the back office for purposes of marking the bank's books to market.[7]

Because of the complexity of exotic transactions such as the P&G Trade, pricing and booking operations were aided by computer spreadsheets, which contained all the terms of the transactions. The spreadsheets would generate the total value, or expected profit, on the transaction, depending on the known terms (such as notional amount and length of time the transaction was to be outstanding) and the variables such as the current price of volatilities and other components of the trade. Traders would save the spreadsheet for a particular transaction to a computer system that could be accessed both by the back-office personnel for purposes of booking the transaction, and by the bank's controllers whose job was to ensure that the accuracy of the bank's books. The responsible back-office person would then enter the new trade figures from the spreadsheet model into the pre-existing inventory of trades for the book.

A chief function of the back office was to mark the bank's investments to market on a daily basis. Marking to market refers to the process of marking the bank's books and records with values for the bank's trading positions that are as close as possible to the market at a given point in time. A bank's trading books must be marked to market on a daily basis in order to provide bank management with an accurate picture

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7 Enforcement Counsel's expert witness testified that institutions generally mark to market using a mid-market volatility figure, about halfway between the bid and the ask price. Testimony from Bankers Trust witnesses established, however, that this was not the practice at Bankers Trust in 1993.

of the bank's investment exposure and allow an assessment of the bank's earnings in comparison to its risk.

As part of the function of marking the bank's books to market, daily statements of profit and loss were generated at Bankers Trust for each of the derivatives books. In 1993, the back office that generated these statements at Bankers Trust received its market input information from the traders, who had the greatest familiarity with the market. When a new trade was put on the books, the trader was not required to use the market inputs that existed on the books prior to the trade. Rather, the trader was expected to determine the appropriate values based on the market at the time, and to mark the new trade and all existing trades in a particular book with the same market inputs. Thus, for example, the T24 book included transactions whose value depended, among other things, on the volatilities of the 5-year Treasury Note and the 30-year Treasury Bond. When the P&G Trade was recorded on November 2, 1993, Fonkenell was not required to use the volatilities for those instruments in use in the T24 book prior to the execution of the trade, but was expected to identify the volatilities in the market and then have the back office mark all of the T24 book consistently with those volatilities. The selection of a particular volatility figure would affect the recorded value of a derivative trade (and, indeed, the entire book).

The day a trade is put on the books at Bankers Trust, its expected value is known as "new deal profit." New deal profit at Bankers Trust was shown on a specific line in the bank's profit and loss explanation system; the remainder of the profit (or loss) realized in a particular trading book shown on the system was known generally as "trading profit." Bankers Trust tracked the profitability of each trading book in the profit and loss explanation system in order to understand and manage its portfolios, and not for purposes of determining trader compensation. Traders were generally expected to maintain or protect new deal profit, and possibly to enhance it, through their hedging and trading activities. Traders made most of their compensation from Bankers Trust in the form of a year-end bonus, rather than as a salary. A trader's bonus was not determined by a simple mathematical calculation based on the profit and loss of his trading books, however. Rather, traders' bonuses were based on a number of subjective factors, including the trader's ability to structure new deals and work with marketers. One of these factors was the trader's ability to preserve new deal profit, but the evidence did not establish that this was the primary or even an important determinant of a trader's bonus.

With respect to the P&G Trade, the lower the volatility figure employed when the trade was first put on the bank's books, the lower the new deal, or expected, profit that would be booked on the first day of the trade. The size of the P&G Trade was so substantial that one point change in either the 5-year or the 30-year volatility figure would result in a profit or loss of $1.5 million; a one-point change in both volatility figures would result in profit or loss of $3 million.

2. The conduct at issue

Fonkenell is accused of manipulating the 5-year and 30-year volatilities recorded in Bankers Trust's T24 book by reporting artificially low figures to the back office on the day the P&G Trade was executed, and then raising the volatility figures over the next several days so that they again reflected the market. This would have had the effect of reducing artificially the "new deal profit" and increasing the "trading profit" associated with the T24 book. The alleged motive for these actions was greed: by artificially increasing trading profit, Fonkenell would allegedly have made himself look like a more competent trader, leading to an increase in his year-end bonus.

The facts relating to the booking of the P&G Trade are complex and involved considerable apparent confusion and misunderstanding between Fonkenell and Mancino, the back-office worker responsible for the T24 book. On November 2 and 3, immediately after the execution of the P&G Trade, Fonkenell was engaged in carrying out extensive and complex hedging activities with respect to the trade, in addition to discussing with Mancino and others the booking of the trade and the allocation of various aspects of the trade to various trading books in addition to T24. Mancino was also occupied with other tasks, and was relatively new to the T24 book. These other distractions may have been partly responsible for the apparent lack of communication between Fonkenell and Mancino; in any event, it is evident from the transcripts of the conversations that Fonkenell was not alone in his lack of clarity.

There appears to be no dispute, however, and the ALJ found, that prior to execution of the P&G Trade on November 2, 1993, the volatilities for the 5-year Treasury Note and the 30-year Treasury Bond were marked in the T24 book at 18 and 10, respectively. There also is no dispute that following the execution of the P&G Trade, Fonkenell directed the back-office worker, Mancino, to mark both volatilities down one, to 17 and 9, throughout the T24 book, and that the P&G Trade was booked with those same volatilities. RD at 25-28.[8] There is no dispute that the volatility for the 5-year Note was increased from 17 to18 on November 3, and the volatility for the 30-year Bond was

[8] Although the P&G Trade was marked with volatilities of 17 and 9 on the day it was executed, the rest of the T24 book was marked at 18 and 9 on that day, because Mancino failed to carry out Fonkenell's instruction and mistakenly lowered the volatility on the 3-year Note, known in Bankers Trust's parlance as "Losh," rather than the 5-year Note, known as "Bosh."

increased from 9 to 10 on November 8. These changes resulted in an increase in the "trading profit" in the T24 book associated with the P&G Trade of approximately $3 million. Finally, there is no dispute that 17 and 9 were appropriate, prudent figures at which to mark those volatilities on November 2, following the execution of the P&G Trade, and that the increases in those volatilities in the following days also reflected the market and were not in any sense "improper" figures. RD at 35.

On the basis of these facts, the ALJ concluded that Fonkenell did not engage in an unsafe or unsound practice or a violation of law with regard to manipulation of the volatilities for the P&G Trade. RD at 34-36. The Board agrees.

Although some evidence in the record suggested that manipulating volatility figures used to mark a bank's books to market could cause management to underestimate the degree of risk associated with the bank's portfolio, no evidence was presented regarding whether this potential existed where the volatilities chosen were within the range of reasonable, prudent market figures.[9] Thus, the record does not reflect that the precise actions of which Fonkenell was accused – manipulating volatilities within the range of prudent market figures – could have caused any harm to the institution. We do not conclude that engaging in a scheme to manipulate volatilities in order to enhance personal benefits is by definition *not* an unsafe or unsound practice, so long as the volatilities chosen are within a reasonable market range. We conclude simply that the evidence in this case does not establish the potential risk of such a practice.

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[9] There is reason to question whether management's assessment of risk could be impaired if volatilities are chosen within a range of prudent, reasonable market-based figures. Evidence in the record showed that marking a bank's books to market involves a number of judgment calls; for example, some banks evidently use a mid-market volatility figure5 for purposes of marking to market, while others, such as Bankers Trust, do not. Management's assessment of risk may well take into account the variation in value that can result from choosing one volatility rather than another equally defensible one.

Moreover, this case involved a single incident of alleged manipulation. Potentially, a different result would be called for if the conduct alleged had involved a pattern of minimizing the volatility figures, but the evidence did not suggest that this alleged manipulation occurred at any other time. Finally, the alleged motivation for the manipulation – Fonkenell's asserted desire to increase his bonus by increasing "trading profit" – also was not supported by the record evidence. Rather, a former Bankers Trust supervisor testified that he did not believe there was any useful distinction between "new deal" profit and "trading profit" in connection with setting a trader's bonus, and that bonuses were set by reference to a large number of subjective measures. Moreover, no evidence was presented that Fonkenell's actual bonus was affected in any manner by the alleged manipulations.

CONCLUSION

The Board has considered the entire record in this proceeding, including the ALJ's Recommended Decision and the Exceptions to the Recommended Decision filed by both parties, and has concluded that the allegations of the Notice are not supported by the record.

Accordingly, it is hereby ordered that the Notice against Respondent Guillaume Henri Andre Fonkenell is dismissed.

By Order of the Board of Governors, this ____ day of March, 2001.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

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Jennifer J. Johnson
Secretary of the Board