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FOREX Market Scandal: Is "Too Big to Fail" Also "Too Big to Prosecute?"

By Sergio Torres LLM Candidate 2015 | October 17, 2014

The first LIBOR scandal caused severe commotion in the banking industry after it unveiled the lack of scrutiny banks exercised with respect to the determination of daily interest rates. However, the international banking industry is now facing a potentially bigger scandal than the first LIBOR interest rate catastrophe. This time, the epicenter of the scandal is the FOREX market.

Foreign-exchange benchmarks are determined daily in order to set initial spot and forward rates for the trading of currency. The criminal charges being imposed on the traders in this case are grounded on the alleged manipulation of these benchmarks in order to favor their daily trading. Trades are usually performed in online platforms, which, based on a determined rate, match buyers and sellers of currency. Rates are based on WM/Reuters benchmarks, which are disclosed every day at 4:00 p.m. London time. The data is collected over one-minute periods within every update. Within this minute new rates are being determined based on past transactions. The high-end traders in this case are being accused of "banging the close." In other words, they are being accused of manufacturing high volume currency trades just prior or within this period in order to improve their positions.

How does it work? Trades consist of orders given to banks for either the sale or the purchase of currency in the market. Once these trades are performed, the market either faces upward or downward pressure. The higher the price of a currency, the more the currency is being demanded in the market, and the same applies for the inverse. If traders place large trades near closing time, they can anticipate the changed rate. Traders can use this information to predict future currency movements and place their own, non-speculative trades in the market right after they have placed the previous order that manipulated the market. Thus, traders can make a profit based on the difference the order creates between the spot rate and the immediate rate that is based on the updated information.

The entities directly implicated in the fraudulent transactions include some of the largest banks in the world. Namely, Barclays Plc. (BARC), Deutsche Bank AG (DBK), Goldman Sachs (GS) Group Inc., Royal Bank of Scotland Group Plc. and UBS AG (UBSN). Other banks involved include J.P. Morgan Chase & Co., and Citigroup Inc., which are two of the largest banks in U.S. These institutions are currently being investigated to determine whether criminal charges (which are take the form of large fines) should be imposed due to the deliberate manipulation of FOREX market benchmarks.

Although individuals within these banks are the ones directly implicated since they are the ones "committing the crimes," the institutions can be vicariously liable, under certain circumstances, for the wrongdoing of their employees. Prosecutors in the U.S. have turned several bank employees into informants in order to gather more evidence against the financial institutions for

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which they worked. These informants are secretly working with the Justice Department prosecutors and the Federal Bureau of Investigation in order to collect this evidence.

Given the latent criminal liability, banks have started to cooperate in the investigations. As a result, numerous settlement agreements have been initiated to avoid further prosecution of the entities and to limit liability to those who purposefully rigged the rates for their benefit. The fallout from the scandal continues, and more than 30 individual traders have been fired from their positions.

Although banks have not yet presented their final estimates of potential fines, the figures could range well into billions of dollars. Fines of this size were seen in the LIBOR scandal of last summer, where billions of dollars in fines were assigned to banks such as Barclays and USB for the fraudulent fixing of LIBOR interest rates.