The Advocate
FOR INSTITUTIONAL INVESTORS

If you ain’t Cheating, you ain’t Trying!

Reputation in tatters? No problem! Wall Street’s Masters of the Universe are at it again – this time pulling the strings to manipulate benchmark rates and financial instruments.

By C.J. Orrico

Despite the purported recommitment to clients and transparency after the financial crisis, a new wave of scandals and serious misconduct have rocked Wall Street in recent years.

The greed and fraud associated with the US mortgage meltdown and global financial crisis of 2007-2008 tarnished the reputations of many large Wall Street investment banks. Post-crisis, Wall Street, legislators and regulators vowed to restore investor confidence in the big banks by, among other things, increasing transparency. For instance, in 2011, Goldman Sachs’ Chief Executive Officer, Lloyd Blankfein, stressed that the vows “represent a fundamental recommitment to our clients.” Despite this purported recommitment to clients and transparency, a new wave of scandals has rocked Wall Street and the global financial markets in recent years. The scandals are massive in scale, and arise from interbank conspiracies to rig global benchmarks and the markets for widely-held financial instruments, in order to reap huge profits at the expense of investors and consumers.

The Libor Scandal

In 2012, an international investigation revealed that since at least 2003, Barclays and fifteen other financial institutions colluded to manipulate the London Interbank Offered Rate, or Libor. Banks use Libor as a base rate for setting interest rates on consumer and corporate loans. Libor affects the costs of hundreds of trillions of dollars in loans used to pay for, among other things, college, cars, and homes.

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For context, over half of the flexible-rate mortgages in the United States are linked to Libor. Despite its importance to the global lending market, Libor was lightly regulated and calculated by a representative panel of global banks — the British Banker's Association or BBA. The BBA would submit an estimate of its borrowing costs to a data collection service each morning, which averaged the rates to determine Libor. Preying on the lack of oversight, multiple bank traders colluded to submit borrowing rates which did not reflect the actual cost to borrow money in order to manipulate the Libor calculation. As a result, the traders were able to substantially limit the risks of their trades and maneuver Libor based on their positions.

The big banks' Libor manipulations resulted in trillions of dollars of financial instruments being priced at the wrong rate. The international investigations, led by US and European regulatory bodies, have led to several major settlements. For example, Barclays settled with authorities for $435 million in July 2012, UBS was fined a combined $1.5 billion in penalties, and Rabobank settled charges for over $1 billion in October 2013. In April 2015, Deutsche Bank also agreed to the largest single settlement related to the Libor scandal, paying $2.5 billion to US. and European regulators and entering a guilty plea. Further, in May 2016, the US. Commodity Futures Trading Commission settled claims against Citibank for abusing Libor and the Euroyen Tokyo Interbank Offered Rate for $425 million. To date, banks have paid over $9 billion in fines and many are still under investigation.

The global probes and enforcement actions have also led to reforms. Since 2014, the NYSE Euronext took over the administration of Libor from the BBA, and is now directly regulated by the Financial Conduct Authority. Moreover, it is now a criminal offense in the United Kingdom to knowingly or deliberately make false or misleading statements in relation to benchmark-setting under the United Kingdom's Financial Services Act in 2012.

The Forex Scandal

Shortly after the investigation of Libor manipulation began, Bloomberg News reported in June 2013 that currency dealers were rigging the foreign exchange benchmark in the $5.3 trillion-a-day foreign exchange market. Once again, the scandal arose from collusion among counterparts at competing banks. Thereafter, an international investigation uncovered transcripts of electronic chat rooms where currency traders conspired to plan the types and volumes of trades. The chat rooms had names such as "The Cartel," "The Bandits' Club," "One Team, One Dream" and "The Mafia." US. Attorney General Loretta Lynch commented that the traders "acted as partners — rather than competitors — in an effort to push the exchange rate in directions favorable to their banks but detrimental to many others." As a Barclays trader exclaimed in one of the chat rooms, "If you ain't cheating, you ain't trying."

The Forex scandal adversely impacted customers around the globe for over a decade. For example, British pension fund holders alone were losing £7 billion a year due to the currency rigging scandal. On May 20, 2015, five banks pled guilty to felony charges by the US Department of Justice and agreed to pay fines totaling more than $5.7 billion and on November 18, 2015, Barclays was fined an additional $150 million. Like the Libor scandal, the investigation concerning Forex manipulations is ongoing with total fines reaching $10 billion to date.

Respective authorities have announced remediation programs aimed at repairing trust in the foreign exchange marketplace. For example, in December 2014, Swiss regulators announced that for two years the maximum variable compensation for UBS foreign exchange employees will be limited to two times the base salary for such employees globally. Additionally, in 2014, the Financial Conduct Authority of the United Kingdom announced an industry-wide remediation program which requires banks to review their systems, controls, policies and procedures in relation to their foreign exchange business to ensure that they are of a sufficiently high standard to effectively manage the risks faced by the business. Senior management at banks are also asked to confirm that action has been taken and that the banks' systems and controls are adequate to manage risks. The Financial Conduct Authority requires the confirmation to ensure that there is clear accountability of senior management at banks.

The Implications of the Libor and Forex Scandals

The adverse economic consequences associated with the Libor and Forex scandals are not yet fully understood. However, the scandals have only increased the public's deeply-held distrust of large investment banks. Aitan Goelman, the Director of Division of Enforcement of the US Commodity Futures Trading Commission, explained, "[t]here is very little that is more damaging to the public's faith in the integrity of our markets than a cabal of international banks working together to manipulate a widely used benchmark in furtherance of their narrow interests."

In an attempt to restore some faith in industry, relevant authorities announced remediation programs for Wall Street. Unfortunately, efforts to hold benchmarks to a higher standard of accountability have so far been piecemeal and regulators in the US and Europe disagree on proposed reforms. Many banks have scrambled behind the scenes to persuade regulators to grant exemptions and a number of banks, such as JPMorgan, received waivers from the SEC to conduct business as usual even after these banks admitted guilt in connection to the various benchmark scandals.

Most troubling is that no government agency is responsible for monitoring many of the financial markets and their benchmarks, which leaves the banks to police themselves. The lack of oversight and the constant pressure to suck profits out of every trade creates an "ends justify the means" culture driving collusion and corruption.

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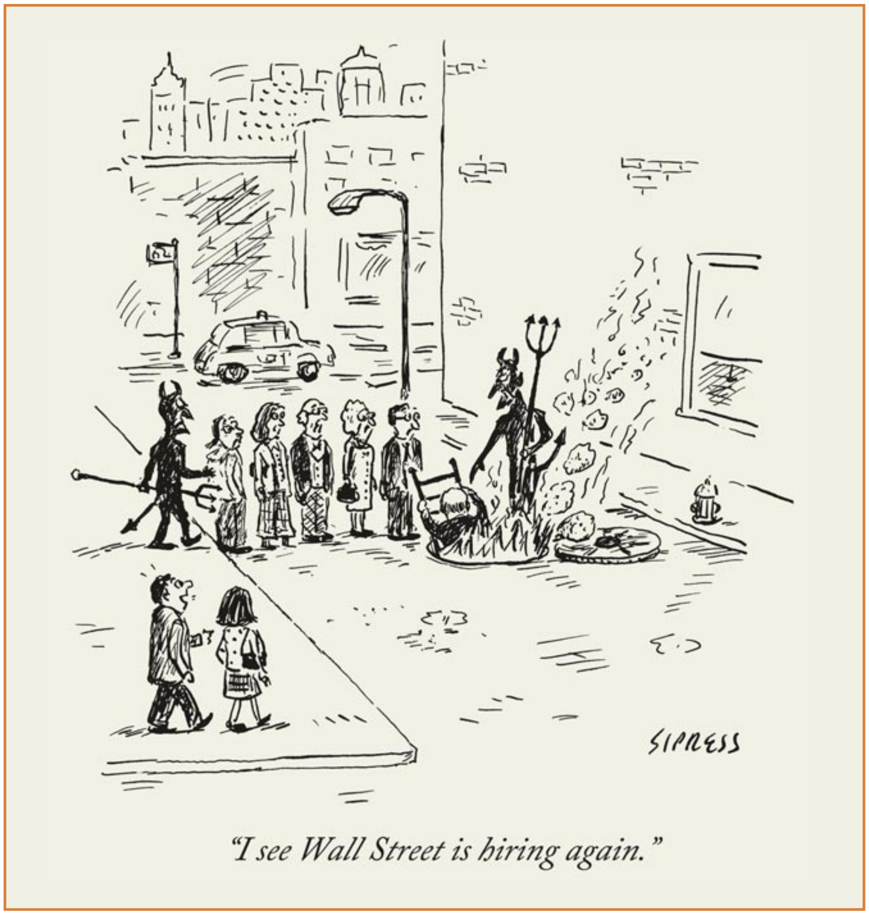
Indeed, in 2015, the Justice Department announced an investigation of at least 10 major banks for possible rigging of precious metal markets including the price setting process for gold, silver, platinum and palladium in London. The Commodity Futures Trading Commission opened a civil investigation as well. The precious-metals probes are just another example of Wall Street's widespread manipulation of major markets, and there are a multitude of examples of investment banks conspiring to manipulate the markets for widely held financial instruments, including credit default swaps, interest rate swaps, and various types of governmental and quasi-governmental bonds.

Unfortunately, for big banks, the fines and investigation are nothing more than symbolic shame—the mere cost of doing business. Many banks remain committed to trading in benchmark markets because it attracts potential corporate clients to, among other things, their highly lucrative mergers and acquisitions business. As such, the victims of the benchmark scandals are left to fend for themselves in seeking to redress Wall Street's illegal conduct. For example, investors defrauded by Bank of New York Mellon in Forex transactions brought suit in the Southern District of New York, and, in September 2015, a federal judge approved a $335 settlement for 1,200 investors. In February 2016, Citigroup paid $23 million to resolve an investor class action concerning allegations that the bank rigged yen Libor to benefit its own position. Further, on May 2016, the Court of Appeals for the Second Circuit reversed a lower court's decision and reinstated a private antitrust lawsuits filed against 16 banks — including JPMorgan, Bank of America and Citigroup — for allegedly rigging Libor interest rates. If the litigation succeeds, the banks could be liable for billions of dollars in damages. While these recoveries are limited compared to the massive harm inflicted by the banks, many investors, like the BNY and Citigroup investors, are increasingly coming to grips with the fact that in a world where regulatory agencies are slow to the punch it is up to investors to protect their own assets from financial fraud and collusion.



"I see Wall Street is hiring again."

David Sipress/The New Yorker Collection/The Cartoon Bank

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