Forex scams

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A **forex scam** is a confidence game played in the context of the foreign exchange market by "customer brokers" or "retail FX brokers" against fairly unsophisticated, under-capitalized "retail speculators." The U.S. Commodity Futures Trading Commission which loosely regulates the foreign exchange market in the United States, has noted an increase in the number of these scams recently [1].

CNN [2] quotes an official of the National Futures Association as saying "Retail forex trading has increased dramatically over the past few years. Unfortunately, the amount of forex fraud has also increased dramatically." Between 2001-2006 the U.S. Commodity Futures Trading Commission has prosecuted more than 80 cases involving FX fraud of more than 23,000 customers who lost $300 million. CNN also quoted Godfried De Vidts, President of the Financial Markets Association, a European body, as saying "Banks have a duty to protect their customers and they should make sure customers understand what they are doing. Now if people go online, on non-bank portals, how is this control being done?"

In the language of con men, the retail speculator is known as the "mark".

The highly technical nature of forex scams, the OTC nature of the market, and, the fact that foreign exchange trading is fairly unregulated, makes exchange rate manipulation or price spiking easy for brokers to commence. Also, this practice is easy to cover up, due to the vast amount of factors affecting the actual market rates. Because of this, these practices could be even more widespread among retail forex brokers than commonly known.

Because of the technical factors mentioned above, the "marks" (traders) on the other side of the trade, or even regulatory authorities, will have an almost impossible task in proving that such manipulation has taken place. Partly because there is no central currency market, but rather a number of more or less interconnected marketplaces, provided by brokers and market makers. Thus, the trader is completely at the mercy of his broker and his broker's market making software and procedures.

Why retail speculators shouldn't be able to beat the market

The foreign exchange market is a zero sum game in which there are many experienced well-capitalized professional traders (e.g. working for banks) who can devote their attentions full time to trading. An inexperienced retail trader will have a significant information disadvantage compared to these traders.

Retail traders are - almost by definition - undercapitalized. Thus they are subject to the problem of Gambler's Ruin. In a fair game (one with no information advantages) between two players that continues until one trader goes bankrupt, the player with the lower amount of capital has a higher probability of going bankrupt first. Since the retail speculator is effectively playing against the market as a whole - which has nearly infinite capital - he will almost certainly go bankrupt.

The retail trader always pays the bid/ask spread which makes his odds of winning less than those of a fair game. Additional costs may include margin interest, or if a spot position is kept open for more than one day the trade must be "resettled" each day, each time costing the full bid/ask spread.

According to the Wall Street Journal (***Currency Markets Draw Speculation, Fraud*** July 26, 2005) "Even people running the trading shops warn clients against trying to time the market. 'If 15% of day traders are profitable,' says Drew Niv, chief executive of FXCM, 'I'd be surprised.' " [3]

Why retail speculators can't beat the market

Forex scammers, posing as customer brokers, use the standard confidence game techniques perfected in bucket shops and boiler rooms.

The spot currency trades placed by retail speculators are made directly with the trader's own "broker," that is, the broker takes the other side of the transaction. Thus, most of these spot trades never enter the open market and are subject to the broker's price manipulation (although some brokers may use the market to "hedge" a large number of unbalanced trades). The broker will almost inevitably take all of the mark's investment.

The marks suffer from at least 5 fatal disadvantages:

- The marks have no competitive prices to trade against, i.e. they must accept their broker's price or not trade.
- The broker may show them actual prices from the forex market, but only with several minutes delay. Thus the broker has better information to trade on.
- The marks are encouraged to over-leverage their trades, thus almost insuring that they will "receive a margin call" allowing the broker to close any open trade immediately, at the broker's price.
- The brokers work as a team of several people as the forex market trades 24 hours a day. An individual trader will not be able to monitor his trades (and his broker's actions) for 24 hours a day. In some cases, the brokers may be aided by computer programs, which have near-instant reaction times and never make mistakes or take breaks.
- The marks look to the brokers for training in the foreign exchange market and may actually buy their trading advice.

Why brokers offer high leverage

By offering high leverage, the broker makes it possible for the retail trader to buy or sell more than his equity allows. In reality, this practice fuels the greed of many traders, who buy or sell too large sums in the market. But at the same time, this increases the trading volume cleared by the broker. And as the broker gets his compensation from the spread, larger trades leads to bigger spread revenue. Also, the traders usage of high leverage enhances the risk, that the trader will receive a margin call if the market moves against him.

It is worth noticing, that while professional currency dealers (banks, hedge funds) never use more than 5:1 leverage, retail clients are offered leverage up to 400:1.

Often traders (the marks) will have a profitable first trade (as manipulated by the broker) in order to increase his confidence in the broker and encourage the mark to "invest" more money. Next, due to the use of too high leverage (often combined with rate spiking) the mark will receive a margin call, telling him that he must deposit more money or his trades will be closed out. The retail FX brokers will do anything to get the mark's money deposited with them, since eventually all this money becomes theirs.

Why brokers guarantee the execution of stop loss orders

With retail FX brokers, traders will be encouraged to trade on margin and set stop loss orders, which allow the broker to close out the trade almost at will during busy markets at prices set by the broker. Very often retail FX traders are forced to trade in lots (10000 of a currency). The practical result is that most retail clients therefore are forced into geared investments.

Trade prices are easily skewed one way or the other, depending on the retail trader's position, which is known by the broker. Marks can be encouraged to take risky positions just before major economic announcements. If all else fails, the broker can quote extreme prices (known as spiking) to trigger stop loss orders while the mark is at work or asleep.

In any case, all of the mark's money will be transferred to the broker without any trade being made in the open market, and without any economic risk being created or destroyed.

Most retail FX brokers guarantee the execution of client stop loss orders. The main reason is that this practice is very profitable. As the client's trade never makes it into any marketplace, the loss generated when a stop loss is triggered is cashed by the broker. This is due to the OTC nature of forex trading, where most often the broker is the one taking the other side of any trade.