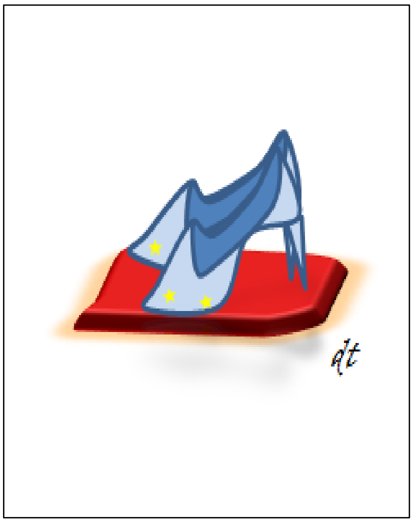
Crystal slippers or an orange suit?

A whitepaper on the challenges of monitoring trading from Alerts4 Financial Markets

Crystal slippers?

When firms begin to consider implementing improved trade monitoring solutions for compliance with market abuse and manipulation regulations, at some point the discussion inevitably turns to the subject of how much will it cost and how does one makes the business case for the necessary investment. Inevitably, senior management with budgetary responsibilities are reluctant to invest in something that does not appear to demonstrate any profitable business benefit. It is sometimes remarked that the Compliance Department up to now has been something of a 'Cinderella' within a firm - necessary to do the chores below stairs but not usually invited to the grand ball. They are a cost centre and not a profit-earner and therefore investment is always viewed as the minimum necessary.



However, the relentless tide of new regulation and increased regulatory and political scrutiny has meant that perhaps times are changing. For the past two years at least, industry analysts have been predicting that technology-related spending on compliance is one of the few areas of IT investment to be rising.

Is Dodd-Frank really the Fairy Godmother then – dressing Cinderella Compliance in finery and crystal slippers and transporting her to the ball in a magnificent carriage, complete with shiny new surveillance system? Or is this just a short term illusion that will all turn back to dust at the stroke of midnight? And perhaps more to the point, what really are the cost justifications that can be used for Compliance to invest a pair of crystal slippers?

Long, long ago…

Long ago, in the time before MiFID (that's before 2007 for those scratching their heads and trying to recall that far back); Compliance was a more sedate affair. Necessary, but rarely of interest or impact at the most senior levels of a firm. Definitely a legal back office function. As a result, staffing numbers for the function were kept to the bare minimum. And as for technology – the words Compliance and Technology were rarely used in the same sentence. At that time, Compliance did not have or need its own technology or technologists. If necessary, reports from existing trading

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systems would provide any necessary information – and of course for analysis – there were always spread-sheets.

Compliance was, in essence then, a manual Cinderella function of the firm. Indeed, it was often criticised as a barrier to doing business, reactive and only good for implementing policies, procedures, handbooks and after the event box-ticking. The belles of the ball were to be found in the Front Office – on the trading floors. Investment was focused on trading staff and the technology that could offer them a critical business advantage – especially speed. The technology arms race was underway and it was enabling ever faster electronic trading over an ever growing range of products and on an ever growing range of execution venues. Within the firm, the gap between above stairs and below became quite startling.

The turning points

So what changed? The major turning points are well-known:

Regulation

In Europe, the conception of MAD in 2003 and later MiFID in 2007 represented not only the liberalisation and equalisation of European trading markets. These acts also marked the start point of the expectations that participants in the markets had some responsibilities and had a part to play in ensuring that they worked properly. It took a while for the penny to drop.

Legislation such as MiFID, gave with one hand (in the establish of a more level liberated trading playing field and the growth in new execution venues) but was subtly taking with the other hand in the establishment of new regulations and an expectation of more transparency and controls.

This then was a turning point for Compliance. It demanded greater involvement and participation in new business development, as well as business as usual. It also marks the beginning of the notion that, instead of being a barrier, demonstrably good compliance could actually provide competitive advantage

And then the first major fault lines in the financial system appeared as a result of the seismic impact of the Lehman collapse in September 2008, heralding the onset of the full-blown global financial crisis.

Rogue Trading

And at the same time, further fault lines began to show with the Jerome Kerviel incident at Societe Generale in 2008, which saw losses of nearly £4bn.

Rogue trading is, of course, not new. It has been a concern ever since the far off days of Nick Leeson and the Baring crash of 1995 which ran up losses of over £800m. However, it seems reluctant to go away. In 2011, another high-profile case of rogue trading came to light. Kweku Adoboli, a trader with Swiss bank UBS managed to lose £1.4bn. His actions wiped £2.7bn ($4.5bn) from the UBS share price, cost fellow traders their jobs and eventually prompted the resignation of the chief executive.

And so it went on in 2012. Bruno Iksil, a trader with JP Morgan Chase, known as 'the London Whale' ran up major losses reported at the time as being $2bn, rising to $5.8bn by July and who knows what

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the actual outcome might end up being. And the Libor rate fixing scandal has run from 2005 to present day.

Scrutiny

You can argue that all these cases represented a wide range of failures - risk management, failures of controls, lack of senior management oversight and are not necessarily within the narrow remit of Compliance. And you may well be right – however they also illustrate other points that are significant in making the case for investment in monitoring and surveillance – single points of failure, a fundamental lack of comprehensive monitoring across the silos and from a different independent perspective. And these failures ultimately led to the disgrace and departure of some of the most senior figures in the firms concerned.

Impacts

The impacts of these headline making incidents was twofold - much greater day-to-day scrutiny by supervisors and even wider attention from politicians and the media. In today's climate, the discovery of any perceived weaknesses and failures in the financial system and the major firms who participate in it are pursued vigorously. Whilst this trend began in the US and Europe, it is now spreading around the world.

Reputation

It is undeniable that the reputation of the whole industry around the world has suffered enormous damage over the last five years. The impact is not just through the eyes of regulators, politicians or even the general public. Levels of trust and confidence have also suffered in the eyes of clients, customers and investors. And the specific reputations and future prospects of individuals and firms have not escaped damage either. The damage of such events in terms of reputation but also in commercial terms and prospects cannot be underestimated.

Sanctions

Fines on UK banks last year totalled a staggering £20bn and still counting. Whilst these include LIBOR and PPI mis-selling, they cover a multitude of other sins including market abuse and manipulation related penalties

Canada-based day trading firm Swift Trade recently lost its appeal to the Upper Tribunal of the Tax and Chancery Chamber in the UK, after contesting an £8 million fine for market abuse imposed by the country's Financial Services Authority (FSA).

The decision to fine Swift Trade was revealed by the FSA last year following allegations the trading firm engaged in a manipulative trading strategy, known as layering, on the London Stock Exchange

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between January 2007 and January 2008. The tribunal described the incident as a "cynical course of intensive manipulation". The fine is the largest ever to be issued by the FSA for market manipulation.

Some jurisdictions are now going beyond purely monetary penalties, notably the US where the 11 year sentence handed to the founder of the Galleon Group in 2011, sent shockwaves around the industry. And following on from that is the increasing trend for identifying (and in some cases pillorying) leaders of the firms who are perceived to be responsible or to have profited from a previously more lax regime that allowed the lapses to occur. Legislation is now moving past corporate sanctions and fines, towards more personal ones, including, ultimately custodial sentences.

And now?

It is clear that the scope and complexity of regulation shows every sign of continuing unabated. In Europe, the original core of legislation has been extended through ESMA guidelines and REMIT and MiFID II and MAD II will continue that trend in due course. Individual countries are also acting unilaterally (for example, Germany is about to pass into law their own new controls on HFT ahead of the new European legislation) and dealing with local market specific issues (HK and warrants, Oz and NDFs, cancel and amends), US and SEFs.

The new Market Abuse Directive, which amends previous legislation dating back to 2003, defines when criminal sanctions should be applied. Its' sister regulation deals with insider dealing and market manipulation. Under a late upgrade, suggested by the European Commission when the Libor scandal came to light, rules against the manipulation of benchmarks, including Euribor, have also been added. Fines will be up to 10 times the amount involved. Notably, jail terms of between two and five years, depending on the crime, are also set out in the directive

What are people doing?

Different supervisory regimes around the world have taken increasingly high profile and hands on approaches to supervision. In response, Compliance departments in most firms are growing. It is one of the few areas of a firm that have increased headcount and are still actively taking on new hires in recent years. Staff movement is visible in many places and salaries are up.

The demand for automated monitoring from supervisors is clear and there is an accompanying expectation that firms take a more proactive and responsible approach. Automated surveillance is considered a must by the world's regulators, not an option. The tide will continue to flow in this direction and is likely to move beyond T+1 monitoring towards intraday and close to real time monitoring in volatile and high volume markets.

There is a growing understanding that good surveillance needs good clean data representing trades, orders, market pricing, and internal reference information for everything they trade and everyone they trade with.

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Progressive firms then are investing in Cinderella and have provided the crystal slippers necessary for her to go to the above stairs ball but what happens as we approach midnight. Will the clock strike and it all turn to dust again – is this a one off jump or a continuing trend.

The costs associated with this are significant enough to have become a major consideration in business strategy, forcing firms to consider the regulatory cost of doing certain types of business. Justifications are needed for the investment, not just in people and salaries, but in the technology and even in data cleansing. Increasingly these need to be looked at holistically and strategically, and not just tactically within each silo, as a knee-jerk reaction to current and specific legislative change.

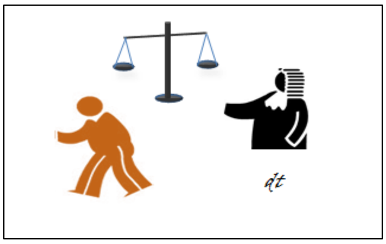
Justifications

So the justifications boil down to these:

1. Meet Regulatory responsibilities
2. Satisfy Supervisory demand
3. Reduce potential to be fined
4. Improve control over operational risk
5. Reduce risk of reputational damage
6. Provide better management oversight

And yet, in some firms the arguments to justify necessary strategic investment are still being hard fought over. Perhaps the ultimate justification is not fear of the supervisor or fear of fines or even fear of losses.

...or an orange suit?



Assuming that most of us no longer believe in fairy tales, probably the most long term value from an investment in surveillance systems is delivered by the information, the most serious detrimental impact from failing to invest could be to the firm's reputation, but the most compelling and immediate argument may be different.

Increasingly it is fear of damage to image and reputation, not just of the firm, but of its' individual leaders – the personal responsibility and the accompanying threat of jail – in terms of US penitential institutions - the infamous orange suit.

So perhaps it is time to enquire whether the decision makers feel the ultimate justification for buying Compliance a new pair of crystal slippers is that it may well help them avoid ending up dressed in an orange suit and ensure that everyone gets live happily ever after.

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