Really real-time? - The relevance of timeframes to surveillance and monitoring

A question that still gets raised and debated periodically is whether there is a need for real-time monitoring and surveillance of trading activity. The argument tends to exclude exchanges of course, they have an obvious need, but for the other market participants? The point is often made that you don't really respond in real-time. It can take months or even years to investigate a case, collect and analyse evidence and bring to book the miscreants, so what's the point of a real time alert?

Well, it may be true that it can take time to investigate a case, but surely the point is not how long it takes to get to the end, but how soon are you first made aware?

If your wallet is stolen, your car driven off or your house broken into, how quickly would you want to know about it and how would you prefer to find out? Is an unexpected tap on the shoulder tomorrow or a shock phone call the day after to tell you that your card has been maxed out, your possessions looted and your prized car a burned out shell your preference? Most of us would prefer to know as soon as possible. We may or may not choose to be a *have a go hero,* to intervene as the offence is in progress and prevent its successful conclusion, but the earlier awareness and damage limitation begins the better. And if vigilance and keeping a careful eye out can help prevent disasters in the first place, we tend to do that too as a matter of course.

Consider credit card fraud for a moment. Perpetrators know that, as automatic surveillance systems have improved, the potential and timeframe to exploit a stolen credit card becomes more and more limited. After as little as 60 minutes they often thrown the card away or sell it on to someone less bright and aware than themselves. So the surveillance systems are providing a level of deterrence and helping to limit the downside, but the sooner the system is aware of a suspicious event, the better the results.

What are the major risks that most concern us?

The most popular answer tends to be getting our wrists slapped by an exchange or worse, the supervisors and regulators. Supervisory visits around the world now tend to look explicitly at surveillance and monitoring, especially for direct market access. Their expectation is that real-time surveillance should exist for this type of trading activity, not only to deter and prevent possible manipulation and abuse, but also as guard against systemic risks. In Europe, especially in the UK, regulators have moved to a point that they expect real time surveillance. In Canada, the recent proposal *Electronic Trading and Direct*

Electronic Access to Marketplaces, states that dealers' compliance staff must receive immediate order & trade information. Their reaction to failures can be censure, significant fines, stopping trading and even custodial sentences.

Suspicious trading events are not something you can ignore. Nobody wants to be the next Barings, SocGen or Lehmans and no-one wants to be found at the root of the next market upheaval or crash. Rogue trading events come and go in the news and arguably their causes can be more complex than a case of poor monitoring. Most people agree that the next upheaval is a not a case of if but when. Operational risks – loss events – are a constant. Although solid and up to date data is hard to come by, global totals for operational risk loss events in Trading and Sales activities in 2007 were a staggering US$5.9 billion. Some US$0.9bn due to fraud and abuse, and nearly half the total related to failures in execution and settlement.

Even if the regulatory penalties and figures for loss events look like the scariest things, probably the most important long-term aspect to be concerned about is the firm's reputational risk. Reputation can take years of hard work and investment to build up, but only moments to irreparably damage, dragging down the business of the firm and many of its staff with it. To be seen to be doing things properly and prudently becomes important in the eyes of clients, whilst been seen to cut corners and do the least possible to comply is becoming a negative attribute.

What can be done?

A recent Tabb group report by Miranda Mizen, pointed to the potential of surveillance systems to offer detection, prevention and deterrence against manipulation, abuse and simple errors and aberrations, from fat-finger trades to rogue algos.

Just to be clear, good surveillance systems are not a question of either real-time or historic analysis - you need both if you are to go beyond simple detection to offer true deterrence and prevention, but the point is that the real-time component and the ability to become quickly aware of events dramatically extends the scope and capability of your surveillance regime.

In the words of one compliance officer, "whereas previously the compliance model had relied on trust with informal systems and controls, and a good compliance culture, regulator's expectations have changed. They are now demanding that management evidence compliance with formal systems and controls. There is a need to develop stronger and more real-time detective controls whilst retaining preventative controls. This more evidenced-based regulatory environment will likely be supported by more frequent intrusive monitor visits, and higher fines for behaviours deemed to be non-compliant must be anticipated."

By focusing on three key components of market surveillance - detection, prevention and deterrence – the Tabb report explained that brokers can gain real-time and historical analysis and oversight to detect anomalies; controls and processes to prevent errant order flow from reaching the markets by applying broker-owned risk controls; and real-time monitoring, control and, acting as deterrents, heavy penalties. "Surveillance will always be a race against time as market oversight must pull together trading activity as quickly as competition pulls it apart." "This can only happen if market surveillance programs and techniques are modern and sophisticated, applied consistently and comprehensively, and are able to keep up with the dynamic markets."

There really isn't much doubt then, that in the view of regulators, commentators and participants themselves, the tide is running strongly in favour of comprehensive surveillance and monitoring, including a real-time component.

The alternative to watching what is going on is not watching what is going on and that seems unpalatable. We really should be doing more in quick time and even real-time.

This article was written by Dave Tolladay – Director of Alerts4 Financial Markets and first appeared on the Tabb Forum in May 2011. For further information please contact dave@alerts4fm.com or visit our website www.alerts4fm.com