OLSHAN

OLSHAN GRUNDMAN FROME ROSENZWEIG & WOLOSKY LLP

Client Alert

Corporate Group March 2012

SEC Staff Issues Risk Alert on Strengthening Practices for Preventing and Detecting Unauthorized Trading

On February 27, 2012, the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission (the "Staff") issued a risk alert intended to assist firms with mitigating the risks posed by "unauthorized trading" in brokerage and advisory accounts. The Staff views unauthorized trading as a "permanent concern to financial institutions and regulators," and the risk alert was issued in the wake of the recent highly-publicized incident at UBS where unauthorized trading in the bank's investment banking division reportedly resulted in a $2 billion loss. In the risk alert, the Staff provides useful insights on policies and controls that may be implemented by firms in order to monitor, detect and prevent "unauthorized trading," which is construed broadly to include (1) "rogue" or other unauthorized trading, (2) exceeding firm limits on position exposures, risk tolerances and losses, (3) intentional mismarking of positions, and (4) creating records of nonexistent or "sham" transactions. In undertaking any review of business practices and internal controls, the Staff recommends firms identify specific circumstances that might permit an individual or group to engage in or conceal unauthorized transactions. The Staff cautions, however, that the recommendations in the risk alert are not complete and "they constitute neither a safe harbor nor a checklist" for firms in complying with their supervisory and compliance obligations.

A copy of the risk alert is attached hereto. If you would like to discuss the risk alert or any matter regarding your firm's compliance controls and procedures, please contact the Olshan attorney with whom you regularly work or one of the attorneys listed below.

Steve Wolosky
swolosky@olshanlaw.com
212.451.2333

Ron S. Berenblat
rberenblat@olshanlaw.com
212.451.2296

Ryan S. Replogle
rreplogle@olshanlaw.com
212.451.2281

National Examination Risk Alert

By the Office of Compliance Inspections and Examinations[1]

Volume II, Issue 2 February 27, 2012

Key Takeaways:

This Risk Alert encourages firms to review their controls designed to prevent unauthorized trading and other unauthorized activities.

Unauthorized activities may include a range of activities. Thus, controls should address: potential unauthorized trading for the firm's own account or for a customer or client account; position mismarking; exceeding trading limits; personal trading activities of associated persons or other employees; and creation and maintenance of inaccurate or altered records.

Strengthening Practices for Preventing and Detecting Unauthorized Trading and Similar Activities

Introduction

Unauthorized trading or other unauthorized activities are not a new problem. Such activities may cause firms and investors to incur losses, and subject firms to legal, regulatory and reputational risks. While broker-dealers and investment advisers are subject to different regulatory requirements, their risk exposures can be similar.[2] In this Alert, we use the term "unauthorized trading" to refer broadly to a range of activities, including:

- "rogue" or other unauthorized trading or trade execution in customer or client or proprietary accounts;
- exceeding firm limits on position exposures, risk tolerances and losses;
- intentional mismarking of positions; and
- creating records of nonexistent (or sham) transactions.

The staff recommends that in any review of business practices and internal controls, firms should seek to identify any circumstances that might permit an individual (or group of

[1] The Securities and Exchange Commission ("SEC"), as a matter of policy, disclaims responsibility for any publication or statement by any of its employees. The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other SEC staff, including in the Division of Trading and Markets, and do not necessarily reflect the views of the Commission or the other staff members of the SEC. *This document was prepared by the SEC staff and is not legal advice.*

[2] With regard to broker-dealers, see FINRA Regulatory Notice 08-18 dated April 2008 (the "FINRA Notice") that addressed risks and set forth a non-exclusive set of practices designed to prevent or mitigate the risk of unauthorized trading. With regard to registered investment advisers, *see* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (December 17, 2003), 68 F.R. 74714 (Dec. 23, 2004).

individuals) to engage in or conceal unauthorized transactions. Such individuals may include traders, trader assistants, portfolio managers, brokers, investment advisers, order placement personnel or trading desks, (collectively, "traders"), as well as mid-or back-office, risk management and other personnel.

One critical element in mitigating the risks posed by unauthorized trading is to have independent and mutually reinforcing controls. Toward this end, firms may want to consider actively engaging such control functions as operational risk, audit, legal and compliance to work closely with management in performing an independent identification of risks and practices that could permit unauthorized trading. A fresh review of reports of past unauthorized trading incidents suffered by the industry may be illustrative in this effort. It may also be appropriate to review and/or test internal controls on a regular basis as well as assessing their adequacy to prevent unauthorized trading in light of internal business changes and current market conditions, among other factors.

Upon identifying any potential weaknesses that could enable unauthorized trading, firms should consider working closely with the above-mentioned control functions to develop enhanced controls and processes to address such weaknesses. Management and non-management employees should be appropriately trained to identify unauthorized activity. Firms also should carefully consider how best to facilitate proper and immediate escalation of any detected activity without fear of retaliation.

Some Insights

Highlighted below are some insights from the Commission's National Examination Program that may help firms identify risks and strengthen their practices for preventing and detecting unauthorized trading. This Alert is not intended as a comprehensive summary of all supervisory and compliance matters pertaining to unauthorized trading; rather, it discusses certain measures that may assist firms in complying with their supervisory and compliance obligations. Firms are encouraged to consider the practices described below in assessing their own procedures and implementing improvements that will best protect the firm and its clients. Firms are cautioned that these factors and suggestions are not exhaustive, and they constitute neither a safe harbor nor a "checklist." Other practices besides those highlighted here may be appropriate as alternatives or supplements to such practices. The adequacy of compliance or supervisory controls can be determined only with reference to the profile of the specific firm and the specific facts and circumstances. [3]

- **Front Office Supervision:** The firm's supervisory structure, both on the trading desk and across the firm, is its most important control. Strong and effective business line supervision at all levels is essential both to promote an overall culture of compliance and to detect and prevent unauthorized trading. Below are some elements that can be considered when a firm assesses its supervision systems.

  - *Define independent and clear reporting lines*. This should include making provision for mutually reinforcing checks and balances, so that more than one person and chain of control are responsible for monitoring the integrity of a business activity.

  - *Knowledge of Complex Securities/Trading Strategies:* In order to provide effective front office supervision, it is important for those within the chain of management and supervision to have an appropriate understanding of the complex products and trading strategies employed by the firm's traders.

  - *Discussions with Direct and Indirect Reports:* Beyond systems-based trading reviews, direct and indirect supervisors (as appropriate) should engage in discussions with traders, portfolio managers and others and review their trading portfolios or account positions on a holistic basis, focusing on any positions that seem atypical or anomalous given the trading strategy or client mandate. Additional discussions and scrutiny may be required with traders responsible for larger trading books or portfolios, or with lesser experienced traders.

  - *Structuring of incentives.* Consider how well compensation packages and other incentives for traders and their supervisors are aligned with responsible risk-taking.

  - *Disaggregation of functions*. Discourage aggregating functions in one trader or desk (e.g., trade execution, booking, clearance, etc.)

  - *Management "Open-Door" Policy:* Firms may want to instruct traders that, if any position begins to lose value in an unanticipated way, the best course of action is to promptly raise the matter with management. An affirmative "open-door" policy that encourages early reporting of unrealized or unexpected losses may permit

[3] The functions performed by traders vary among businesses and among firms. Traders typically may perform trade execution functions while other aspects of the lifecycle of the transaction, such as booking, clearing and settling a trade, are handled by other personnel or departments. However, there may be situations where traders have some role in such other functions. The practicality of some of the practices described below may depend in part on the specific role performed by a given set of traders, as well as by factors such as their compensation structure, the manner in which trades are cleared and settled, etc.

management to identify and address problems before they manifest themselves in greater harm to the firm and/or its clients or customers.

- *Trading and Booking Systems Reviews:* In addition to discouraging aggregation of trading and post-trade functions (as discussed above), only certain individuals should be granted access to these systems (including for the prevention of insider trading and other violations of securities laws and rules). It is therefore appropriate for supervisors (either directly, through a control function, or more formally through their audit department) to periodically review which traders and other persons have access to particular trading books to determine that their access conforms to their business needs. In particular, the supervisor may want these reviews to focus on ensuring that employees' "legacy" access is removed so that only the appropriate personnel have the ability to book trades into particular portfolios.

- *Potential Additional Controls and Scrutiny:* Supervisors, legal/compliance and operational risk personnel may find it prudent to assess the need for specific additional controls or heightened scrutiny. Some of these controls may lend themselves to daily monitoring.

  - By way of example, some additional controls or heightened scrutiny that could be monitored on a daily or intra-day basis may focus on:

    - trade breaks, unfilled bids and offers, paper tickets and changes in venues where trades are executed;
    - changes in trading patterns;
    - concentrated risks;
    - audit trails;
    - unusual or high volume of error account activity (*e.g.*, cancel/corrects);
    - aged inventory monitoring;
    - manual trade adjustments;
    - unexplained or uncorrelated profitability to a specific book or investment mandate, profile or risk tolerance for a particular trader or client;
    - instances where trades are inappropriately reported to the tape but not cleared, and vice versa; and
    - concentrations of profitable or unprofitable trades, or patterns of trades and offsetting trades, with the same counterparty.

  - Other controls or areas for heightened scrutiny that may also be considered for monitoring on a regular basis include

    - frequency of risk limit breaches;
    - frequent requests for trade limit increases for the same counterparty;
    - reasons for and patterns in remote access to trading accounts;
    - robustness and integrity of controls for trade capture, confirmation and validation; and
    - incentives created by compensation arrangements or promotion criteria.

- Where anomalies are identified that suggest the need for additional analysis and investigation, steps that firms may wish to consider include

    - review of personal and family investments and trading accounts, to the extent that the firm requires that these be available to it for surveillance;
    - review of changes in lifestyle that may evidence an unexplainable increase in wealth; and
    - collection and review of email, phone logs and other communications such as text messages or social networking activities, to the extent that the firm requires these to be available for surveillance.

- **Transfer of Personnel into Trading Positions:** Firms may from time to time offer a trading desk position to personnel from other areas in the firm. Providing employees new opportunities in different areas of the firm may be positive in many respects. At the same time, personnel from areas such as operations, finance or risk control groups that move into trading desk positions may take with them awareness of any idiosyncratic process "workarounds" or procedural weaknesses that could be exploited to hide unauthorized activity. Firms may wish to take this into account in assessing internal controls and securities safeguards on systems, as well as in supervisors being alert to any "red flag" indicators of possible unauthorized trading. In all events, firms are encouraged to determine that all systems access permitted as part of an employee's prior position is terminated prior to any trading by such a transferred individual employee. Some firms terminate all system entitlements, other than payroll-related entitlements, for employees who transfer functions. By treating such employees as a "new hire" with respect to system entitlements, firms have greater assurance that such employees no longer have inappropriate access to mid-or back-office systems. Also, on a periodic basis, supervisors may want to engage a control function or the firm's audit department to verify that unneeded system access has been properly terminated.

- **Extended Settlements/"Rolling" of Positions:** Both extended settlement trades and apparent client or firm positions that are rolled over many times can be cause for potential concern. Firms may wish to consider carefully the development of special supervisory reviews, exception reports or other tools to review transactions that feature extended settlements or "rolls" of positions, based on frequency, length of settlement extensions or extensions that are inconsistent with normal or standard conventions applicable to the particular trading instruments. In some cases, it may be appropriate to contact the client/counterparty to ensure that such person knows the trades as well. As a particularly strong control and a parallel safeguard to its order management system, some firms require a verbal independent confirmation by a designated mid- or back-office person of each extended settlement trade, within minutes of the order being created.

- **Trade Confirmations:** Broker-dealers of course are required to give or send confirmations of securities transactions to their customers.[4] However, inter-company

[4] Securities Exchange Act Rule 10b-10.

transactions where confirmations may not be present and certain delays in obtaining client signatures or authorizations (if any are required) may merit additional scrutiny (*e.g.*, for confirmations of many securities-based derivative transactions) to ensure that such absence or delay is not hiding unauthorized trading. Similarly, the street-side "comparison" process should also be reviewed to ensure that it is not being used to facilitate or hide unauthorized trading. Management may want to consider providing training to middle and operations personnel to emphasize the need to receive timely signed confirmation acknowledgements and when to escalate backlogs.

- **Mandatory Vacations:** Policies requiring mandatory vacations without remote access to trading accounts have been adopted by many firms, requiring traders and perhaps certain other personnel to be out of the office for a period of time (*e.g.*, 10 consecutive business days), without any out-of-office access to the firm. This policy, however, may not necessarily *on its own* bring any unauthorized trading to light, especially if fictitious trades have been booked to the firm. For firms that adopt such mandatory vacation policies, supervisors may consider how best to assign the management of the trader's portfolio(s) to another trader during the trader's absence. For example, it may be prudent to assign the book to another supervisor or to a "peer" trader, as opposed to a less-experienced trader. Similarly, a supervisor may want to do a special review of an absent trader's portfolio(s) during expiration to detect any unusual activity. More generally, firms may wish to consider limiting or eliminating the type of remote trade-book access (e.g., electronic, phone) that traders have while away from the office.

- **Independent Trading Reviews:** Firms should consider actively engaging their audit department and/or control functions such as their compliance department and their financial, credit and operational risk units to periodically check trading strategy, business performance and risk profile.[5] Independent valuation, and validation, of trading positions including any hedging transactions, is an important control. Also, with respect to "strategies," it is important to validate whether traders are actually following a prescribed strategy and whether the performance risk of each strategy is appropriate for the firm's risk profile.

- **Silo Systems:** An additional risk area faced by many firms is that transaction information may exist in multiple automated or other recordkeeping systems. These situations could exist due to: (1) legacy acquisitions; (2) the use of multiple trading platforms; and (3) the use of various security types. The existence of multiple systems may make it difficult to observe, manage, identify and report on transactions seamlessly across a firm. Firms may, as appropriate, work to align disparate systems either through robust reporting, data migration or middleware products to ensure "full picture" monitoring.

- **Control Testing:** Finally, it may be appropriate to periodically test the controls designed to identify unauthorized trading activities. Tests may need to be conducted and reviewed

5 Risk profile includes market, credit, liquidity, trading supervision and operational risk including review of operational incidents, if any.

by supervisors, or their designees, and, if appropriate, those independent of the businesses with knowledge and experience in both trading various securities and the systems used to support various trading desks.

- **"Tone From the Top":** Past unauthorized trading incidents and regulatory guidance[6] underscore the need for a firm's culture of compliance to be one that is articulated and followed by top-level senior management and one that emphasizes honesty, integrity, accountability and responsible risk-taking, as well as the need for rigorous supervisory and compliance control systems that emphasize quick and proper escalation without fear of retaliation. Financial firms operate in an environment focused on performance but must also create a culture where personnel can acknowledge that the firm's reputation and financial well-being is a shared responsibility. Traders should report unexpected and unusual losses early in order to prevent such losses from becoming worse, and potentially becoming disastrous. Non-trading personnel should be trained to be sensitive to suspicious activities and encouraged to quickly escalate any activity that seems unusual or inconsistent with compliance, financial and operational controls. Management should not tolerate any activity designed to discourage employees from quickly escalating concerns, such as bullying or inappropriately relying on seniority to impede openness.

Conclusion

The risks posed by unauthorized trading are a permanent concern to financial institutions and regulators. The staff hopes that the observations shared above will be helpful to firms in strengthening their compliance and supervisory controls regarding unauthorized trading.

The staff also welcomes comments and suggestions about how the Commission's examination program can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy.

If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

---

[6] FINRA has emphasized the importance of not ignoring unauthorized trading merely because it proved to be profitable, as well as the importance of a "tone at the top" from senior management that establishes a strong corporate culture of compliance. FINRA Notice, *supra* note 2, at 1, 6.