

5 Questions...

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NEW FEATURE!

5 Questions seeks out experts in their respective fields to answer...well, five questions on topics of importance to securities industry professionals in the field of compliance and regulation...



Proprietary Trading Reviews

1) The \$7.1 billion trading loss in Societe Generale SA is an extreme example of what can happen when a trader goes astray. What went wrong? The preliminary investigation states the failure to identify the fraud is due "to the efficiency and variety of the concealment techniques employed by the fraudster, secondly to the fact that operating staff did not systematically carry out more detailed checks, and finally to the absence of certain controls that might have identified the fraud." In other words: 1) The trader was too smart to be caught; 2) Management did not properly manage trading; and 3) The tools were not good enough.

2) Are these problems common among both large and small firms?

Absolutely. Both large and small firms can have smart traders who are not monitored properly and the IT tools may be insufficient to identify problems on a timely basis. The loss at Societe Generale SA was caused by just one trader. The complexity of derivative products require equally sophisticated systems to monitor activity. Managers must understand both trading and systems. A superstar trader with a consistent and highly profitable track record may be effectively ignored by his manager because the manager simply does not understand the trades and is hoping against hope that profits continue. There is often a reluctance to delve too deeply because it may upset the superstar. Senior management may be completely unaware of a ticking time bomb because they are relying on that first line manager.

Our guest: Fergus Henehan

Fergus Henehan has more than 25 years of experience as a senior executive, including designations as Chief Administrative Officer and Chief Financial Officer, at both national and regional broker dealers. Mr. Henehan started his securities industry career as an Internal and Branch Auditor, and later became a Registered Representative and Branch Manager for a large national broker dealer. Mr. Henehan was a member of the NASD Financial Responsibility Committee and the Financial and Operations Principal Exam Committee. After a successful career as an expert witness in which he testified in over 40 arbitrations and trials in both Federal and State courts, Mr. Henehan is now a Principal and founding partner of The Sutro Group LLC.

5 Questions: Proprietary Trading Reviews (cont.)

3) What are some basic procedures to properly avoid fraudulent trading activity?

All trading activity must have certain fail safe mechanisms intrinsic in the process which should help protect the firm from trader fraud. Having these procedures in place will mean the trader must have a co-conspirator to successfully perpetrate the fraud (historically, trading scandals have generally been perpetrated by a single rogue trader):

- 1) Trades are done with counterparties. If there is a strong, independent system in place to confirm all trades with counterparties, fictitious trades should be quickly uncovered. Normal equity and bond trades in U.S. and many foreign securities go through an automated clearing and settlement system which should quickly uncover discrepancies. However, if the trader is trading non-system cleared securities, counterparty confirmation is mandatory and the counterparty must be credible. All trades must be confirmed quickly and consistently; and
- 2) Accurate pricing is critical. Most securities are system priced by independent pricing firms. However if a trader is in effect pricing his own proprietary positions, there is danger -- these positions must be carefully reviewed every day.

4) When a compliance professional is looking at firm inventory are there data points which may help uncover existing problems?

Yes, most firms have access to firm inventory reports which provide the following data:

- Oldest positions
- Largest positions
- Hand priced positions
- Positions with the largest unrealized profits and losses
- Concentrated positions relative to the trader's limit
- Trading limit overages

“If that junior trader drives to work in a brand new Porsche, make sure he is a trust fund baby and not simply selling his uncle bonds for 20% under market...”

- Trade corrections by trader, especially account changes
- P&S breaks by trader

There are always exceptions but these potential problem areas are prime targets for more thorough scrutiny.



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5 Questions: Proprietary Trading Reviews (cont.)

5) Do you have some final thoughts on what senior management can do to create an environment which discourages rogue traders?

Senior executives who are not directly responsible for trading or firm inventory also play an important role in the process of protecting the firm's capital from fraud on the trading desks. Higher level firm inventory reports (at the desk level rather than by trader) should routinely be distributed to all senior managers and these reports and any accompanying exception reports should be on the agenda of every senior management meeting. When somebody asks about a particular trading strategy and nobody in management can explain it easily, there is potential for catastrophe. When a particular trading desk has significantly higher P & S problems and trade corrections than the norm, send in the auditors and get to the root of the problem. If that junior trader drives to work in a brand new Porsche, make sure he is a trust fund baby and not simply selling his uncle bonds for 20% under market.

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