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Risky business: Strong supervisory and internal controls are the best defense



By Steven Goldberg, principal,
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One need look no further than the recent and much-publicized rogue trading scandal at a major investment bank to see what can happen when supervisory and internal controls fail. Over the course of months, a junior-level trader allegedly managed to make enormous unauthorized trades totaling upward of \$73 billion that ultimately resulted in a loss of \$7.2 billion for the bank. The effects may have even radiated to the markets, creating volatility as the bank tried to unwind the trades.

Although the ultimate story and facts will take many months or years to come to light, early indications and reports indicate the alleged rogue trader was able to bypass controls because he worked in the “back office” and had intimate knowledge of how trades were processed. According to published reports, he worked late to disable controls in the bank’s computer system to hide his massive trades. The trader also used colleagues’ logins and passwords and employed simple tricks like falsifying emails to thwart his supervisors.

The purpose of having supervisory and internal controls in place is to detect and respond to such actions early. However, a firm must be diligent in its implementation and follow-through of these controls.

Other financial institutions should let situations like these serve as the impetus to re-examine their own risk management models and systems and inspire renewed diligence enforcing internal and supervisory controls. In the United States, legislation is in place to ensure companies

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take these protective measures. For the securities industry, the Financial Industry Regulatory Authority (FINRA) requires that the CEO certify that supervisory controls are in place. The Securities and Exchange Commission (SEC) has stated that it will be examining risk management procedures at most broker-dealers.

Steps toward compliance

The first steps toward confirming that the appropriate internal controls are in place are to complete an assessment and test of risk management procedures and supervisory controls. This process includes:

- Completing annual FINRA testing of supervisory procedures and remediating identified issues.
- Reviewing and documenting internal controls and procedures for managing risk, as required by FINRA and recommended by the SEC.
- Assessing market risk relating to trading activities and firm inventory, including value at risk models, stress testing and economic models.
- Continuing to maintain current records documenting systems of internal risk management controls as required by regulators.

In addition, broker-dealers should:

- Identify new businesses or new regulations that would impact testing. Has a previously existing business become more important or risky as a result of financial or regulatory changes?
- Identify ineffective or inadequate supervisory procedures that will require remediation.
- Address the New York Stock Exchange's (NYSE) Rule 342, "Offices—Approval, Supervision and Control," internal controls requirements.
- Plan and schedule testing with the various areas.

Taking responsibility

With so many areas falling under the umbrella of supervisory controls and risk management, it is imperative that specific roles be designated to carry out these tasks. The risk management process begins with senior management. In environments in which there are mounting pressures for staff to perform, the tone must be set from the top that compliance is the main priority, even when there is a decision to be made between supervisory responsibilities and financial gain. Managers and supervisors must understand that they are expected to make the right decision and not put the



firm at risk. In a smaller firm, these roles will often overlap and exemptions may be made for the independent supervisory testing requirements of FINRA 3012. This makes the development of clear written policies and procedures even more vital for those firms.

An independent internal audit function is essential; the SEC has stated that an effective internal audit function is a key element in managing risk within a firm. The internal audit group should be expected to present a thorough risk assessment to the audit committee, which should also provide independent oversight throughout the audit process. The risk assessment should focus on operational risk, regulatory risk and market risk. An operational risk assessment may detect areas of weakness in IT security and internal controls relating to systems access.

Additionally, the chief compliance officer must meet regularly with the CEO to discuss the supervisory control systems, as required by FINRA 3013. The heart of the supervisory control system is the written supervisory procedures (WSPs), which become the basis for the supervisory responsibilities for each business unit within the firm. The WSPs must be updated as business conditions change and should be independently tested as part of the FINRA 3012 and NYSE 342 reporting requirements.

Written supervisory procedures are the guiding force for the firm's behavior when it comes to internal controls, operations, technology and financial areas. The procedures should also address market risk and the use of pricing models. The use of pricing models should be fully documented along with clear limits, lines of authority and escalation procedures. Any new business should undergo assessment for market- and operations-related risks. Effective surveillance and monitoring is critical — in today's fast electronic markets, automated surveillance

systems, electronic alerts, integration with internal trading systems and outside counterparties should be considered.

On a basic level, the level of supervisory controls required can be driven by the importance of a particular business to a firm's revenues. U.S. firms are required to provide a heightened level of scrutiny in cases where a supervisor is responsible for a desk generating a high percentage of the revenue in a particular business area. While the alleged rogue trader was a relatively low-level trader, it is reported that he managed to make sizable gains with his risky bets. Institutions should expand their scope to monitor any uncharacteristic spikes in performance.

As evidenced by the case of the major investment bank, risk management has been thrust into the limelight and will not be leaving the stage in the foreseeable future. In this environment, firms must create a culture of compliance, instill supervisory and internal controls and conduct regular testing and risk assessment. When it comes to risk management, the lesson here is to be proactive. •



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Steven Goldberg is a principal in the business advisory services practice in New York, where he specializes in the financial services industry. Steve has more than 25 years of business experience, with 20 years in financial services as an industry executive and management consultant.

He has spoken at many noted industry forums and has published several articles and white papers on relevant business and technology issues affecting the industry. Steve has forged client relationships with a number of global financial services firms — leading sales and delivery teams and coordinating services and resources within the U.S. and in several international locations.

He has provided a wide range of advisory services, including regulatory compliance and controls, business process improvement, program management and IT strategy and integration. His clients range in size from development-stage enterprises to multinational companies. Steve's areas of expertise include business strategy and operations, information technology/IT strategy, mergers and acquisitions, and program management. He received a Bachelor of Arts from City University of New York.

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