

SWX Europe *compliance*

Newsletter from the SWX Europe Regulation and Compliance Department
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We hope you will find this issue of SWX Europe *compliance* useful. We welcome your comments and suggestions.



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Market Notices

Since the last *compliance*, Market Notices 08/2008 to 14/2008 inclusive have been issued:

Market Notice	Date	Content
08/2008	26.02.2008	Banque Pasche SA - de-activation of a Member ID
09/2008	26.02.2008	Changes to Directive 9 (Fees) - new Tariff model from 1 April 2008
10/2008	27.02.2008	UBS AG Zurich - additional Member ID
11/2008	29.02.2008	E*TRADE Securities Limited – resignation on 7 March
12/2008	05.03.2008	Van der Moolen Effecten Specialist BV - additional Member ID
13/2008	18.03.2008	St. Galler Kantonalbank - start of trading as a Member on 25 March
14/2008	02.04.2008	Rule and Directive changes – confirmation of changes to the Directives for the migration of the ETF market to the Quote System – see below

All Market Notices are available at www.swx europe.com in the Regulation section.

Updates to Rules and Directives

There have no changes to the Rules since *compliance* 19.

The changes to the Directives since *compliance* 19 have been:

Market Notices	Directive	Summary of changes	Effective date
09/2008	9: Fees	Implementation of the new Tariff model – see below	01.04.2008
14/2008	5: Attributes for Quotes 9: Fees	Confirmation of the changes in Market Notice 04/2008 dated 31 January 2008 for the migration of the ETF market to the Quote System	10.04.08 for: <ul style="list-style-type: none"> 90 second trading halts to prevent executions outside the spread of market maker quotes removal of the closing auction for the ETF market <p>The changes to Directive 9 (Fees) will apply to ETF market makers on migration to the Quote System</p>

New Tariff model

The key features of the new Tariff model are:

- each product segment (Swiss equities, Pan-European and ETFs) has its own scale of trading fees
- members have a choice between two fee scales; a Poster/Aggressor model (Asymmetric) and a Balanced model (Symmetric), each with a fixed transaction fee and a turnover-related (ad valorem) fee, subject to caps and floors
- off order book trades cost less than order book trades
- when an order is executed in several tranches (partial executions), all tranches of that order on the same trading day are collated and one transaction fee charged
- discount bands are offered depending on the monthly fee commitment levels
- trading turnover is converted into Swiss Francs on a daily basis. Trading fees are calculated and converted to the member's domestic billing currency at month end
- ETF Capacity Fees will be introduced when ETFs migrate to the Quotematch platform.

Members can switch between tariffs at the beginning of each month; a request must be submitted in writing at least 7 calendar days in advance via the form available in the secure Business Member Section of our website (www.swxeurope.com). The Master User has the authority to request such changes, as does the individual who performs the newly created role of "Tariff Change User".

An additional Trade Type Code, "AG" for Aggressor Trade, was introduced with the new fee model. This system-generated Code is automatically attached by the Order System to the member's own trade message and the trade slip message which is sent to the Trading System of the "aggressor" of a trade. Members can use this Code to distinguish trades in which they were the aggressor from "poster trades" and "auction trades".

FSA's Market Watch

On 11 March, the Financial Services Authority (FSA) published issue 25 of Market Watch.

This reports that, following a public announcement of unauthorised trading by a firm, the FSA has followed very closely the various reports which have been made public, as well as being in contact with international regulatory colleagues.

The full text of Market Watch 25 is available from the FSA's website at:

http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter25.pdf

The following is an extract:

"We recognise that, in view of the criminal investigation in France, and of the ways in which the 'rogue trader' appears to have disguised his activities, there is likely to be more to learn in the future.

Our supervisors have been speaking informally to 40 - 50 of the largest trading banks in the London market about how they have been applying the lessons learned. We were pleased to hear that almost all had discussed internally the relevance of this case to their own business, and many had already put in place reviews to ensure they identify any gaps in trading controls and close them as soon as possible.

So, from this work, we are highlighting the sorts of measures which firms should consider when reviewing the systems and controls which protect them against 'rogue trader' risk.

The current volatile market circumstances significantly heighten the chances that inappropriate practices could quickly lead to record losses, so early discovery and remedial action are even more important than in 'normal' times."

Sally Dewar, MD, wholesale and institutional markets, FSA, has commented: "We are encouraged that many firms in London with significant trading activities are working to satisfy themselves that their basic controls and governance surrounding trading, risk management and settlement are effective" and "But the risks remain, and we would urge firms to remain vigilant on unauthorised trading, especially in current market conditions."

SWX Europe members may be interested in following these developments and the following questions which the FSA is encouraging firms in Market Watch 25 to consider:

Front office culture and governance

Q1. How does the firm make sure that the right incentives are in place to promote appropriate oversight and governance in the front office?

- Firms should consider the quality of the routine Management Information (MI) as well as exception reports available to trading management and whether they need updating or varying – in light of business changes as well as this 'rogue trader' incident. In addition, consideration should be given to how clearly responsibilities and reporting lines are set out. Firms should consider whether there are clear incentives in place to make sure that control and oversight by front office management is promoted and rewarded.
- For example, if a trader has a high number of cancelled and amended trades in a period, firms should consider if this would be brought to the attention of senior trading management and control functions through routine reporting.
- Firms should also consider whether the front office culture is designed to prevent 'rogue trader' activities. For example, are traders encouraged (or required) to take two- week continuous holidays? As well as being a useful tool in catching a 'rogue trader' this could also prove to be a preventative measure. Firms could also give consideration to 'desk holidays' where traders take a break from marking or valuing their own books, and a colleague takes over this responsibility.

Trading mandates and limits

Q2. How does the firm make sure that appropriately specified trading mandates are in place, that they are up to date and are monitored against?

- Firms should consider whether there are trading mandates in place for each trader, and how detailed these mandates are – for example, do they set out the products and markets the trader can trade along with corresponding risk limits? Additionally, consideration should be given to which parties agree and sign the mandates – are traders, trading management and risk management all involved?
- Firms should also consider whether this mandate is used as the basis for monitoring the activities of the trader by both front office and independent control functions, and whether a proper process of escalation and challenge is in place to investigate any breaches of these parameters.

Control functions: culture and challenge

Q3. How does the firm make sure that the control functions are sufficiently skilled and can provide effective challenge to the front office?

Q4. How does the firm make sure that the checks and controls work as they are intended?

- Firms should consider whether there are persons in all areas of the control functions that have sufficient understanding, skill and authority to challenge front office staff effectively when agreed parameters for activity are breached or when something else suspicious takes place.

- For example, is the use of suspense accounts understood by middle and back office, and challenged when used inappropriately by front office? Is suspicious activity across these accounts escalated to, and acted on, by senior management?

- To support the effective implementation of processes and procedures, consideration should be given to management's commitment to recruiting and retaining quality staff as well as the provision of appropriate training.

Risk management and limits

Q5. How does the firm make sure that that all material, exotic and basis risks are captured?

Q6. How does the firm make sure that there are limits in place against all material risks and that they monitor all risks regularly to assess their materiality?

- Firms should consider whether they have mechanisms in place to monitor traders' positions by reference, for example, to trader mandates and overall desk position, for all material risks.

- Firms should also consider the monitoring of those risks that may be difficult to capture as part of a portfolio or firm level risk measure; for example, exotic and higher order risks, basis risks and liquidity risk. In these cases, consideration should be given to useful tools such as gross notional limits or gross sensitivity limits.

Management information

Q7. Is the management information on key performance indicators sufficiently detailed and appropriate?

Q8. How does the firm pull together information across different middle office teams and control functions to make sure that poor performance and/or suspicious activity is spotted?

- A trader who trades different products and/or markets may be subject to monitoring by different middle office teams. So it is therefore important that firms consider the monitoring of operational key performance indicators at a trader level. Firms should also consider whether these indicators are appropriately escalated and aggregated to enable senior control and front office management to assess a trader's performance across different areas.

- For example, would a number of 'yellow' flags in different areas be aggregated to produce a 'red' flag if there are common control concerns with a particular trader across different areas?

- Consideration should also be given to concerns raised by a body outside of the internal monitoring framework. For example, would concerns raised by an exchange be escalated and appropriately aggregated with other MI to highlight common control concerns? Would issues raised by an exchange be investigated and verified independently of the trader concerned?

Off-market rates

Q9. What controls are in place to make sure trades booked at off market rates are flagged and challenged?

- Firms should consider the controls that are in place to check transactions done at an 'off-market' rate. These are important in their own right, for example in a market abuse context, but can also be an important element of the systems and controls to prevent 'rogue trader' fraud.

- This matters because an attempt to alter the profit and loss (P&L) may require the trader to enter trades at an off-market rate. By doing so, the trades could reverse any P&L the trader may have incurred on other positions.

P&L attribution

Q10. How does a firm make sure that it understands where all the P&L is coming from, including P&L from more exotic risk and basis risks?

Q11. Does the firm understand where large day-one P&Ls movements are coming from and whether they make sense?

- P&L attribution is a key control for understanding the risk in a trading operation as the P&L is the outcome of the risk taken. So, understanding where the P&L is coming from is very important for firms, especially where more complex products or basis risks are traded.
- Firms should consider whether any large day-one P&Ls are adequately analysed – on both simple transactions and more complex trades – as well as cancelled and amended trades with a large P&L impact.

Reconciliations

Q12. How does the firm make sure it has the necessary reconciliations in place and that they operate effectively?

- Reconciliations are essential controls to ensure positions are consistent throughout the firm's systems (e.g. reconciliations between front-office, risk management, and back-office systems), and with the outside world (e.g. confirmations and reconciliations with custodians, nostro accounts, exchanges, and brokers). Firms should therefore consider whether their reconciliation processes have been prudently designed to prevent gaps or significant points of weakness, and to help identify and resolve breaks.
- Consideration should also be given to the use of key performance indicators (for example, around aging of unresolved breaks) as these can be an important operational control to monitor and enforce the robust implementation of reconciliation processes.

Confirmations

Q13. How has the firm organised its confirmation processes and controls to minimise the risks associated with unconfirmed trades?

Q14. How does the firm make sure that the management information it produces is sufficiently detailed to track adequately the risk profile of outstanding confirmations?

- Clearly, transactions between firms have to be confirmed to make sure the positions booked on a firm's system are accurate and firms should also consider the confirmation of internal trades. However, firms should think about whether they have a framework in place to track and analyse outstanding confirmations together with a process for escalation to senior management if the service level agreements are not adhered to.
- Firms should also consider whether reconciliations are done directly between operations functions rather than involving front office. Although we recognise that the procedures for confirmations vary between markets and counterparties, we understand that the practice in most firms is for confirmations/valuations to be sent directly from external counterparty/ providers to the middle or back office, not via the front office.
- In this context, consideration should be given to the use of oral affirmation processes – i.e. telephone confirmations between operations functions where the existence and key economic factors of the trades are confirmed. These can be a useful near-term control tool, pending the completion of full documentation and confirmation processes.
- Specific consideration should be given to certain unconfirmed OTC trades which may have characteristics that pose greater risks. One example would be an OTC trade with no near-term cash-flows with a counterparty with whom there are no collateralisation arrangements in place.

Margining, collateralisation and cash management

Q15. How does the firm make sure that its margining process is working properly and that any changes are reconciled to the relevant positions on its book?

- Large positions usually require large margin or collateral calls. Therefore, firms should consider their reconciliations of margin and collateral calls to a trader or a book to help make sure that the margin calls are correct and that the positions on the book are accurate.
- In addition, consideration should be given to the analysis of subsequent gross and net cash-flows and whether these can be understood in the context of the trader's mandate, positions and reported P&L. For example, if significant net cash-flows are identified, is it clear that these are offset by unrealised and unmargined/uncollateralised gains or losses elsewhere?

Segregations of duties and IT security

Q16. How does the firm make sure that access controls are adequate and that its security measures are adhered to?

Q17. Does the firm have scope to enhance segregation of duties arrangements to limit the likelihood of malicious action by a single unauthorised user?

- Firms should consider whether IT security and access controls are properly implemented to ensure that users may only access those functions that their duties require - for example, 'maker-checker' distinction or access only to those trade entry mechanisms that correspond to trader mandates.

Firms should also consider whether these system access rights are revisited afresh on a periodic basis. Consideration should be given to specific steps that need to be taken in circumstances when people move from the middle or back office to working in the front office (or the other way).

- Elementary IT precautions cover issues such as whether access to systems is password-dependent, and whether passwords are shared or easy to guess. One common control is to require users to change their passwords from time to time and to exclude users from the system if they enter the wrong password more than a few times. Another control firms could consider are location checks – for example, is a front office person logging onto a computer in the back office? Firms should consider whether they have a security conscious culture as peer pressure or a lax environment can assist the sharing of passwords.”

Topics for Future Compliance Newsletters

We welcome topics for inclusion in future issues of *compliance*.

Please contact us with suggestions. Thank you!

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