

# Financial Services Disputes and Enforcement

## Catching Kerviel: A toolkit for thwarting rogue traders

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Jerome Kerviel, an ostensibly unremarkable Frenchman from Lyon, and now very much a former derivatives trader at Societe Generale, the second biggest bank in France, is accused of accruing EUR 4.9 billion losses for his employer through entering into unauthorised futures positions totalling approximately EUR 50 billion. Kerviel's alleged "rogue" trading appears to have evaded SocGen's systems and controls not for days, but for months.

In the fallout of the SocGen meltdown, the FSA has discussed the issue of systems and controls both with many of the biggest banks that it regulates, and also with its continental counterparts. Following this consultation, the FSA's Markets Division has last month published a Newsletter on Market Conduct<sup>1</sup> that seeks to provide a steer for FSA authorised firms seeking to shore up their internal defences, and prevent them from suffering SocGen's nightmare: their own Jerome Kerviel.

Set out below is a toolkit that may be helpful to any investment firm that is re-assessing its internal defences against rogue traders. The guidance is comprised of: (1) three key principles that we believe must always be borne in mind; (2) a summary of questions that investment firms should ask themselves in light of the FSA Market Division's recommendations; and (3) a brief reminder of the key FSA organisational rules that investment firms are subject to.

### THREE GOLDEN RULES

#### Senior management responsibility

Much has been made of the degree of blame to be levelled at SocGen's senior management for failing to keep track of Kerviel's actions. It is clear that, under the UK regime, the buck stops with the firm's senior management. The FSA's rules provide that senior personnel must be ultimately responsible for ensuring that the firm complies with its regulatory obligations. In particular, senior personnel must assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the firm's regulatory obligations, and take appropriate measures to address any deficiencies. Of particular relevance is the requirement that senior personnel receive frequent written reports on the status of the firm's systems and controls, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies. Additionally, many of the FSA's rules, for example those on risk management (SYSC 7.1.4R) and segregation of functions (SYSC 5.1.7R) explicitly provide that it is the senior personnel's duty to ensure that the requirements are satisfied by the firm.

#### Principles-based regulation

The FSA's approach to regulation has changed, and so must the approach by investment firms to compliance. The "principles-based" or "outcome-focused" approach to regulation means that those subject to FSA regulation must move beyond the box-ticking approach to compliance, and must devise their own proportionate methods of complying with the purpose, spirit, and intended objectives of the rules. Clever technical arguments on compliance are not likely to wash with the FSA if the objectives that drive the high level rule or principle are not met.

#### Documentation

All key internal organisation structures and processes and all transactions must be properly documented, stored, and must be easily retrievable. This will make it much more difficult for employees to operate undetected, makes it clear who is responsible for what, and provides hard evidence for the firm to show the FSA that it has considered its obligations and has acted accordingly.

### FSA MARKET DIVISION'S RECOMMENDATIONS

#### Front office governance, culture... and rest

- **Information flow** - Are the routine Management Information, and the exception reports, of sufficient quality, and sufficiently available to front office management? Do these need updating or varying? In particular, would unusual transactions such as those carried out by Kerviel be brought to the attention of senior trading management and control functions through routine reporting?
- **Lines of responsibility** - How clearly are responsibilities and reporting lines set out within the investment firm? Are there clear rewards to incentivise front office management to exercise the appropriate control and oversight?
- **Rest** - Are sufficient efforts made to ease the strain on traders, for example by ensuring that traders are required to fully utilise annual holidays?

#### Trading mandates

Are there sufficiently comprehensive trading mandates that set out the products and markets the trader can trade along with corresponding risk limits in place for each trader? Who signs the mandates? Are traders, trading management and risk management all involved? Are the mandates periodically reviewed by independent control functions, and is there a process of challenging and escalating breaches of the mandates?

<sup>1</sup>Market Watch - Issue No. 25 (March 2008) - Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues.

## Control functions

Are there persons in all areas of the investment firm that have sufficient understanding, skill and authority to challenge front office staff effectively when agreed parameters are breached, or when suspicions are aroused? Is there a commitment to recruiting and retaining quality staff, as well as providing appropriate training?

## Risk management and limits

Are there mechanisms to monitor traders' positions by reference to mandates and overall desk position, for all material risks? Are there monitoring mechanisms for risks that may be difficult to capture as part of a standard portfolio or firm level risk measure, such as exotic, higher order, basis, and liquidity risks?

## Management information

**Yellow and Red Flags** - Are trader key performance indicators appropriately monitored, and are indicators appropriately escalated and aggregated to enable senior control and front office management to assess a trader's performance across different areas? Would several "yellow" flags for unusually good/bad performances in different areas aggregate to produce a "red" flag?

**Heeding external warnings** - Would concerns raised by another firm, an exchange, regulator, or other body be correlated with other Management Information, and escalated accordingly?

## Off-market rates

Are there controls in place to check transactions done at an "off-market" rate?

## Profit and loss attribution

Can the P&L be clearly attributed, especially where more complex products are traded?

## Reconciliations

Have position reconciliation processes been prudently designed to provide results that are consistent cross-departmentally, and also externally, and to prevent and identify gaps or significant points of weakness?

## Confirmations

- **Outstanding confirmations** - Is there a framework to track and analyse outstanding trade confirmations and a process for escalation to senior personnel if confirmations remain outstanding beyond a certain timeframe? Is extra attention given to unconfirmed, high risk OTC trades?
- **Oral confirmations** - Are the existence and basic features of trades confirmed between operations functions by telephone, followed by documented completion and confirmation?

## Segregations of duties and IT security

Are IT security and access controls properly implemented to ensure that each user may only access those functions that his/her duties require? Are those access rights reviewed on a periodic basis? Is there a culture of security-consciousness? For example, are users required to periodically change their passwords? Is password sharing prohibited?

## FSA OBLIGATIONS

The key FSA obligations to be borne in mind when an investment firm is reviewing defences against rogue traders are summarised as follows:

- **Principle 3 (Management and control)** - Take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- **Organisational requirements (SYSC 4.1)** - Establish, maintain and monitor robust governance arrangements, clear organisational structure, well defined lines of responsibility, effective risk management, and sound internal controls.
- **Regular monitoring (SYSC 4.1)** - Regularly monitor adequacy of systems and controls.
- **The management (SYSC 4.3)** - Senior management are ultimately responsible (see above).
- **The employees (SYSC 5.1)** - Employ personnel that are suitable, and have the skills, knowledge, and expertise necessary for the discharge of the responsibilities allocated to them.
- **Segregation of functions (SYSC 5.1)** - Personnel may perform multiple functions only when they can do so soundly, honestly, and professionally.
- **Risk control (SYSC 7.1)** - Establish, implement, maintain, and monitor adequate risk management policies and procedures.

## CONCLUSION

It is hoped that the three "golden rules", the summary of the FSA's recommendations, and a reminder of the FSA rules will provide a helpful toolkit to any investment firm reviewing its internal defences against rogue traders.

**Please contact Tim Pope or Thomas Webb of Burges Salmon LLP's Financial Services Disputes and Enforcement Team if you would like to discuss these issues further.**

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