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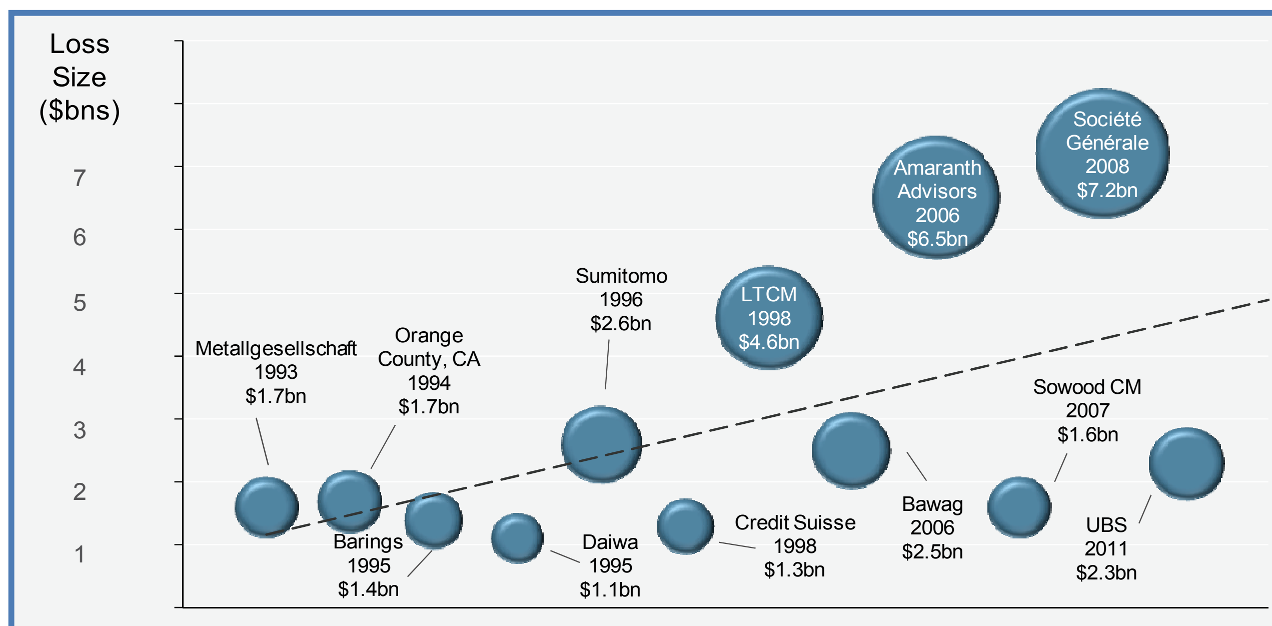
Is Your Company Vulnerable to a Rogue Trader?

Financial instruments are powerful tools utilized by traders to manage market risk. However, things can easily go wrong when transactions are managed inappropriately, or an individual intentionally attempts to transact outside of approved boundaries and conceal his or her activities. To mitigate the potential for such risk, companies typically implement risk policies, as well as robust middle and back office control infrastructures.

Most traders respect the rules and utilize them properly to the benefit of their employers. Still, as the chart below illustrates, history is filled with cases of organizations that have suffered unexpected and significant trading losses due to an employee's actions.



To identify indicators of increased risk, prudent companies, regardless of the infrastructure and controls they have put in place, will continue to perform proactive analyses of their trading and hedging operations and the people and controls surrounding such operations.

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Primary Drivers of Rogue Trading Incidents

Rogue trading activities may manifest themselves in a variety of ways, but the most common drivers are attempts to manipulate incentive compensation plan results or hide an error. The compensation of traders generally has a significant variable component heavily weighted to the mark-to-market (MTM) results of their trading activities. As a result, many rogue strategies are focused upon altering or enhancing the profitability of various transactions in order to benefit the trader. This often includes concealing losses. Alternatively, a trader may make a costly, but innocent, mistake and attempt to hide the error and trade out of the loss rather than face the scrutiny and potential consequences of his or her actions. Because these represent normal human behaviors, it is unlikely that such occurrences can be avoided completely. This is why regular diligence within the control infrastructure surrounding trading operations is so important – and why additional, constant oversight and analysis are necessary.

Recent events also highlight potential issues associated with the transition of middle and back office personnel into the role of a trader. Normally, companies believe that this approach can enhance the overall control environment. However, these individuals, if motivated improperly, know and understand the control environment and have close relationships with the personnel involved, making it easier to exploit weaknesses within the control environment. Issues such as these should be evaluated closely.

Examples of Rogue Trading Strategies

The following represent examples of typical strategies employed by rogue traders. There are indicators and analyses that can be deployed to evaluate and detect the potential for exposure to such strategies.

Front Running	A trader with knowledge of a transaction to be executed by the company will trade in his or her personal accounts in advance of the transaction in order to benefit personally from anticipated market movement.
Desking a Deal	A trader executes a trade with a third party, but does not tell anyone or capture the trade in the system. This approach is utilized to hide the trade. For this strategy to work, the trade eventually must be entered into the system for settlement purposes. Typically, this strategy is only relevant in the over-the-counter (OTC) markets.
Round Trip Trades (Wash Trades)	A trader enters a significant OTC transaction in which the price, volume, location and term is offset perfectly. The transaction results in no credit, cash flow or liquidity exposure, but is used to boost transacted volumes and revenue. Typically, this strategy is only relevant in the OTC markets.
Off-Market Transactions	A trader colludes with an OTC broker or counterparty to execute transactions at off-market prices. This strategy would be utilized to shift profits between companies and/or for personal benefit. In the case of OTC brokers, it could be performed in exchange for personal benefits that the trader receives from a broker for executing off-market trades with a third party and entering them into the portfolio.
Physical Manipulation	Through multiple strategies, traders manipulate transportation capacity, production or supply within a market in order to artificially increase or decrease the availability of physical product in the market. This strategy typically results in a rise in prices within a specific market that can be exploited for gain. These strategies have many names, including Fat Boy, Get Shorty, Ricochet and Warehousing.

Cornering the Market	A trader attempts to acquire a significant percentage of the open interest in a market or a subsegment of the market. This strategy may involve trying to buy and store as much of a commodity as possible to increase market prices, and often exposes the trader to significant market risks. When a trader holds a significant percentage of the open interest in a market, the fair value of the position must be considered suspect.
Misstate Deal Terms	A trader will misstate the quantity, price, location, term or counterparty of a transaction within the system to hide risk, avoid violation of a limit, or prevent detection of a deal. At some point, either the transaction has to be entered into the system to be settled, or the counterparty will call and ask about the transaction. This generally occurs in the OTC markets.
Mismark Price Curves	A trader mismarks a price curve within the system to alter the MTM value of transactions and hide gains or losses within the portfolio. This also may be performed through Level 3 modeled price curves, where incorrect assumptions are used to alter the MTM value of select transactions. This risk is most prevalent in OTC markets.
Broker Account Management	A trader uses his or her authority to control and administer a broker account to alter the terms of the relationship, distribution of statements, or distribution of confirmations. These actions serve to decrease the ability of others to validate account activity. This typically occurs in the exchange markets, but also can occur in the OTC markets.
Altering Settlement Terms	A trader or a middle or back office employee alters the settlement terms of a transaction to favor a particular counterparty or as a result of personal inducement. This strategy generally requires collusion and is only relevant in the OTC markets.
Redirecting Payments	A trader or a middle or back office employee directs payments or margin calls to a location or account other than the location or account approved by the company.
Writing Options to Generate Cash or Revenue	While not a fraudulent transaction in and of itself, a trader may write options to generate cash to cover margin calls on transactions with significant losses. Other traders have tried to record option margins received as revenue. This is an indicator of increased risk within the portfolio.
Rollovers	A trader will roll the loss from an existing transaction into the next settlement period, rather than settle the loss in the current period. This concept is similar in nature to an off-market transaction. Rollover strategies generally occur in the OTC markets.
Banging the Close	A trader will execute a series of transactions on the exchange within the closing window in order to raise or lower the settlement price. This strategy is executed to enhance compensation tied to the value of the remaining open exchange positions or, more likely, to enhance the value of OTC transactions in which settlement is tied to an exchange index. This strategy is most effective in illiquid markets, where the acceptance of a limited amount of losses on exchange contracts can result in significant gains on OTC transactions. This strategy is more difficult to detect because it involves a series of transactions; intent also must be analyzed.
Index Fraud	A trader reports incorrect pricing information to publishers who generate indices used to settle OTC transactions to manipulate an index used to value OTC transactions.
MTM vs. Accrual Gain Manipulation	A trader executes a transaction with a counterparty that is designed to alter a company's accounting. There are many variations, but all involve off-market pricing. Such transactions generally are designed to manipulate the period accounting results for an accrual company, while remaining profitable for the trading company.
Investor Funding Manipulation	A trader takes in investment funds from third parties and falsifies investment reports and payout statements to customers. These types of "Ponzi" schemes have occurred many times over the years in various markets. This is often one of the most significant concerns of investors and a focus of their reviews.

Masking Debt	A trader enters into an off-market swap to generate up-front cash flows in connection with a long-term MTM transaction. The off-market swap represents financing or factoring activity that is disguised as an operating transaction.
Commingling Customer and Company Accounts/Funds	A trader commingles customer and company accounts or funds to hide transactions or finance trading positions.
False Counterparties	A trader falsifies the identity of a counterparty to hide transactions with inappropriate or previously rejected counterparties.

Although not exhaustive, the above represent examples of rogue trading strategies that are designed to impact compensation or to hide inappropriate transactions. To identify indicators that such strategies may be in play within an organization, companies must evaluate the nature of the portfolio, the compensation program, the existing control environment and the personnel involved. Based upon the profile of the portfolio and the instruments involved, as well as changes in the value of the portfolio, specialists can focus on particular risks.

The mere existence of such an indicator does not necessarily imply that a rogue trading strategy has been deployed or a loss has occurred, but it does indicate that additional analysis and investigation are warranted. More invasive procedures that involve overseeing personal and family trading activities and investments, evaluating the lifestyle and activities of personnel involved in the trading operations, and analyzing email, text messages, phone logs, social networking activities and other similar procedures may be utilized.

The Importance of Trading Controls and Oversight

Every time a trading loss occurs, companies evaluate and reinforce their trading controls, systems and processes. There are many fundamental controls that represent the backbone of a sound trading control environment. These include items such as timely trade capture; timely trade confirmation and validation; appropriate book structures that allow for disaggregation and tracking of risks; validation of forward curves; validation of models; daily risk reporting; risk analysis, including value at risk (VaR), stress tests and scenario analyses; and strong segregation of duties. These controls must be supported by robust applications that allow the company to manage the transaction life cycle appropriately and provide robust reporting capabilities. These concepts represent the basics of proper trading control. Most important is that such controls are truly monitored on a daily basis and that regular sweeps occur to look for and identify potential risk outliers.

Advanced risk analysis includes monitoring the portfolio and operations for risk outliers and other unusual information that may allow the company to discover an issue before it becomes significant. These represent activities that go well beyond processing transactions and printing position reports. Various forms of this activity include analysis of, among other things:

- Off-market transactions
- Changes in trading patterns
- Unfilled bids and offers
- Concentration risks
- Incentive compensation plan targets
- Exchange vs. OTC positions
- Career progression paths and incentives
- Late entries
- Audit trails

Such risk analyses will need to be customized to the markets and trading activities of the organization. Diligence in performing these types of analyses is where the chief risk officer, the trading control group or the middle office adds value to the organization.

Is Every Trading Loss the Result of Rogue Activities?

No. Losses will occur, even among the best traders in the market. A well-thought-out strategy may be deployed within the market, but the market can easily turn in a different direction than expected due to a variety of circumstances. This is why ongoing risk analysis and communication regarding strategies deployed are so important.

Further complicating risk analysis is the use of more exotic and complex trading and hedging strategies, which may be deployed in an attempt to manage risks that cannot be perfectly offset in the market, or to take advantage of expected market movements. Such strategies should be closely evaluated and approved by management. Traders also should make sure their employers know and understand the complexities and risks involved with using these strategies, as it is often difficult for companies to distinguish between trading losses driven by the failure of a complex or exotic trading strategy and a rogue trading strategy.

About Protiviti

Protiviti (www.protiviti.com) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit. Through our network of more than 70 offices in over 20 countries, we have served more than 35 percent of FORTUNE® 1000 and Global 500 companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

Protiviti is a wholly owned subsidiary of Robert Half International Inc. (NYSE: RHI). Founded in 1948, Robert Half International is a member of the S&P 500 index.

How We Can Help Evaluate Your Organization's Vulnerability to Rogue Trading Losses

There are no guarantees, and it is difficult to prevent a trader from engaging in a rogue trading strategy. The goal is to create a control environment that regularly analyzes and evaluates such possibilities to detect current issues, as well as identify potential issues at an early stage in order to mitigate the impact of such occurrences. Protiviti personnel have investigated numerous trading losses and have also assisted control organizations and internal audit staffs in analyzing and evaluating potential risks within trading portfolios. Further, Protiviti personnel have assisted many organizations with building and enhancing their control and reporting infrastructures to detect such events at an early stage. Everyone hopes that a rogue trading loss will not happen to their organization, but a fresh set of eyes to look at infrastructure and risks may be a good idea.

Contacts

Cory Gunderson
Managing Director – U.S. Financial Services Practice Leader
Global Leader, Risk & Compliance Solutions
+1.212.708.6313
cory.gunderson@protiviti.com

David Johnson
Managing Director – Market Risk & Commodity Trading Solutions
+1.713.314.5020
david.johnson@protiviti.com

Randy Marshall
Managing Director – Financial Services Risk & Compliance Solutions
+1.212.603.8365
randy.marshall@protiviti.com

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