
**The Progressive Evolution of Enhanced Trader
Surveillance: 10 Key Findings**

INTRODUCTION

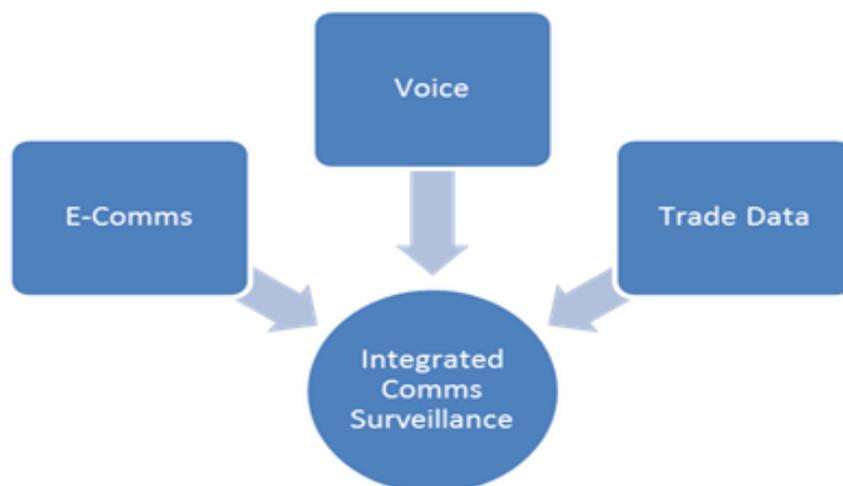
This White Paper considers how the investment banking industry (and individual firms within it) is responding to immediate and pressing regulatory requirements placed upon firms to implement fit for purpose communications surveillance tools. It is a **must read** for any compliance expert grappling with the short, medium and long term challenges faced by firms in complying with legislation intended to improve trade floor surveillance, including MiFID II, MiFIR, MAD and MAR¹.

Based upon a number of interviews with participants from ten leading Tier 1 and Tier 2 investment banks, senior UK, US and European surveillance compliance experts highlighted their views of the regulatory landscape and their approaches to date in identifying and then implementing a holistic surveillance solution, integrating voice and electronic communications with trade data.

BACKGROUND

As matters currently stand, from 2017 firms will be obliged by legislation to provide enhanced communication and market surveillance, a move beyond simply recording trader communications and trading activities². Whilst a possible amended timeframe for MiFID II implementation is unlikely to materially affect its content, there is a general feeling within the industry that legislation and operational expediency are ultimately pulling firms toward a holistic integration of communication and trade surveillance. As one compliance expert sums up, “[the market] must move towards analysing the ‘three pillars’ of voice communications, electronic communications and trade data” in order to identify market risks and take appropriate action to mitigate those risks.

The “Three Pillars” of Integrated Communications Surveillance (as identified by participants)



There is a general acknowledgement amongst participants to this study that firms *should* by now be well down the road towards defining and implementing a robust holistic surveillance solution, leveraging the best of people and technology and integrating the “three pillars” seamlessly. However, with little practical direction from regulators, a confused approach towards

¹ Markets in Financial Instruments Directive II, Markets in Financial Instruments Regulation, Market Abuse Directive and Market Abuse Regulations

² NB whilst there is currently some debate amongst EU lawmakers around delaying the MiFID II implementation date to 2017, it is still a distinct possibility that some of its provisions will be phased in during 2016, coming into force in 2017

implementation timetable, and limited understanding within the industry as to what is truly expected of it, is enough being done to meet the requirements for enhanced trader surveillance? Firms who do nothing or delay, waiting for the bandwagon to pass by before climbing aboard, face extensive reputational damage as well as significant fines for failing to meet their regulatory obligations.

The clock is ticking and the time for firms to demonstrate enhanced market surveillance capabilities is fast approaching. Will the industry be ready in time?

EXECUTIVE SUMMARY

Due to issues of historic non-compliance and operational failures over recent years a number of Tier 1 and Tier 2 investment banks have undergone senior level restructurings. As a consequence, Chief Compliance Officers - challenged with “getting their houses in order” – are expressing concerns about readiness in general, and in particular having in place a robust and holistic suite of tools and resources to monitor and analyse trading communications and data.

Interviews with senior compliance stakeholders exploring their current and future capacity to meet their enhanced communications surveillance obligations identified 10 key findings:

1. Voice monitoring is the next key area for firms to develop
2. FX and Commodities are immediate priorities (although in reality all asset classes are in play)
3. Firms wish to see a holistic solution available to monitor and analyse trade data, voice and e-comms
4. Firms felt there are still further opportunities to improve trader surveillance technology
5. Firms are not coordinating their approaches towards enhanced communications surveillance
6. Regulators are providing little practical guidance on legislation
7. Most firms are currently taking a people driven sampling approach to monitoring voice communications
8. Some firms are adopting a “wait and see” approach to implementing holistic technology, however there are notable ‘early adopters’
9. There are perceived challenges in implementing a robust holistic solution in the short term
10. Cost, however, is not a deal breaker

Whilst firms accept that technology has a key role to play in helping them meet their obligations, it is clear that any solution needs to be cost effective, scalable, and provide “near to real time” reporting.

Surprisingly, firms seem unaware of advancements already made towards achieving a holistic solution, but some first-movers are ahead in their thinking and are leading the field with a mix of market leading technology complemented by expert compliance resource.

THE 10 KEY FINDINGS

Prominent surveillance experts from leading Tier 1 and Tier 2 investment banks were asked about the challenges they face in meeting regulatory demands for enhanced surveillance obligations, and questioned about their approaches towards implementing a holistic surveillance solution, integrating voice and electronic communications with trade data.

The 10 key findings that follow represent a thematic distillation of participants' responses.

1. VOICE MONITORING IS THE NEXT KEY AREA FOR FIRMS TO DEVELOP

With the FCA canvassing opinion on regulatory surveillance obligations, and with other regulators offering strong 'hints' following prosecutions, all firms recognise that voice surveillance will be the next area subject to intense regulatory scrutiny.

Firms felt that whilst current stand-alone approaches to monitoring e-comms and trade data were relatively robust, voice communication surveillance systems currently operated by firms – which are required to add “flavour and context” - were under-developed.

2. IMMEDIATE PRIORITIES ARE FX AND COMMODITIES (ALTHOUGH IN REALITY ALL ASSET CLASSES ARE IN PLAY)

There is a general acceptance by firms that FX and Commodities are key areas of risk requiring immediate attention, albeit with a recognition that all asset classes must ultimately be covered.

In the very short term, any asset class with exposure to a benchmark rate will be in the cross hairs of regulators.

3. FIRMS WISH TO SEE A HOLISTIC SOLUTION AVAILABLE TO MONITOR AND ANALYSE TRADE DATA, VOICE AND E-COMMS

Whilst the FCA and other regulators expect firms to consider all types of surveillance, sentiment across firms was that they currently had no “one stop shop” solution for integrated communications surveillance, with firms possessing instead standalone modules with little or no link to wider risk management tools.

Expectations as to when a holistic solution would be available ranged from between 3 and 5 years, the implication being that this would not be in time to meet any final deadline set out by MIFID II.

However, some few Tier 1 firms indicated that they were in a more advanced state of preparedness, readying a holistic solution for roll out in 2016.

“We’re still working out how to get a meaningful holistic approach. We don’t have all of the pillars – voice, e-comms and trade surveillance – to put the roof on yet”
– Senior Risk Consultant, Tier 1 Bank

“there is nothing on the market as far as I’m aware to allow us to go beyond what we are currently doing” – Global Monitoring and Surveillance Head, Tier 1 Bank

4. FIRMS FELT THERE ARE STILL FURTHER OPPORTUNITIES TO IMPROVE SURVEILLANCE TECHNOLOGY

The perception amongst firms is that there are further opportunities available for them to implement reliable integrated technology solutions, particularly in relation to voice surveillance. This perception has led to some firms going it alone and building their own capabilities – not always viewed by peers as the right approach.

Specifically, firms wish to see a solution that leverages Artificial Intelligence to “learn” from previous activities, generates meaningful alerts as events happen (not after the horse has bolted), possesses Big Data processing capabilities, and brings together the best of “man and machine” to meet all of a firm’s requirements.

“The answer *must* be technology” –
Director, Tier 1 Bank

“We’re some way away from a robust [technology] solution. There’s a lot of talk but it is early days” – Global Head of Monitoring and Surveillance, Tier 2 Bank

“Currently it’s like saying, “fly to the moon!” But we haven’t yet got a rocket” – Chief Operating Officer, Tier 2 Bank

5. FIRMS ARE NOT COORDINATING THEIR APPROACHES TO ENHANCED COMMUNICATIONS SURVEILLANCE

Of frustration to many was the lack of joined up thinking within the industry with firms acting in isolation from one another. The need for an industry wide approach and best practice was seen as a genuine response, but that shepherding the number of interested stakeholders involved – even just within a single firm – was viewed as a challenge.

Part and parcel of acting collectively is creating a consistent approach to informing regulators about different types of product risk, but also limitations with technology and process. Without this, it was felt that there was a very real prospect of regulators receiving (and then giving) mixed messages, and firms needlessly exerting effort rather than sharing the load.

“We need industry consensus around ‘what we will look at’. We’re not sharing notes” – Managing Director Compliance, Tier 2 Bank



6. REGULATORS ARE PROVIDING LITTLE PRACTICAL GUIDANCE ON LEGISLATION

Despite consulting with firms around their surveillance obligations, regulators have provided little by way of actual practical advice to help firms understand what is expected of them under legislation including MiFID II, MAD and MAR. Views ranged from it not being the regulator’s “problem” to a perception that even regulators are not clear what is involved and, therefore, have no advice to offer.

“There’s no real help from the regulator, although they will benchmark your progress (or lack of it) against peers” - Head of Conduct and Surveillance, Tier 1 Bank

Similarly firms gave mixed messages as to how flexible

“Regulators accept a flexible approach but

regulators are being given the technological issues firms are facing. At one end of the spectrum some viewed regulators as being understanding and tolerant, whilst at the other end of the spectrum others suggested that “regulators simply don’t care” about the technical challenges.

“don’t want firms to hide behind the challenges as an excuse for not enhancing surveillance” - Senior Risk Consultant, Tier 1 Bank

7. MOST FIRMS ARE TAKING A PEOPLE DRIVEN SAMPLING APPROACH TO MONITORING VOICE COMMUNICATIONS

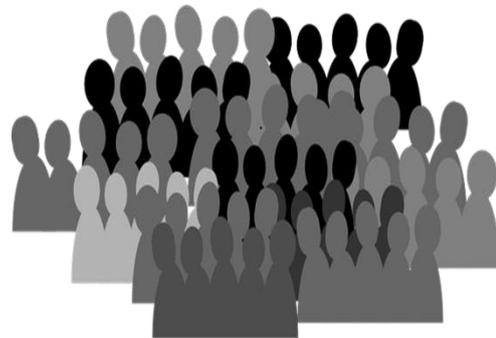
It is hardly surprising, what with the prevailing view that communications surveillance technology can be further improved, that some (but not all) firms are throwing human resource at the problem of monitoring and analysing communications - not without its own challenges.

“Improving technology has to be the answer with human compliance input. We will always need people supported by technology” – Director, Tier 1 Bank

However, given the volume of voice data being collected, compliance analysts can only review a small fraction of this and firms have therefore adopted sampling techniques to focus effort. These tactical methods differ from firm to firm but include: lexicon based sampling; random sampling of voice comms; sampling during periods of peak activity; “after the event” sampling following an investigation e.g. FX or LIBOR; sampling by risk profile of trading desk. Put simply, each firm operates differently.

“[The problem] with people is you have to rely on their gut feel to “sniff out” a problem” – Head of Strategic Change, Tier 1 Bank

Specifically in terms of voice communications, sample sizes range from 30-60 calls a week (a Tier 2 Firm) to 3,000 calls per day (a Tier 1 Firm). Clearly the scale of sampling reflects the number of compliance analysts and anecdotally some compliance teams have increased in size from 10 to 200 in a matter of months (in the case of a Tier 1 Firm), with one Firm reporting growth of 400% in two years. To accommodate the cost of these scaled up teams, some firms have located in lower cost locations.



It is generally accepted that even with more robust technology in place, there will always be a role for the human analyst but at present the balance of effort is wrong.

8. SOME FIRMS ARE ADOPTING A “WAIT AND SEE” APPROACH TO IMPLEMENTING HOLISTIC TECHNOLOGY (HOWEVER, THERE ARE NOTABLE EARLY ADOPTERS)

Although some firms are facing internal and external pressures to investigate an integrated technology solution now, many are adopting a “wait and see”

approach and are looking to emulate first mover firms who are ahead of them in the development and implementation cycles.

This is less to do with cost, and more to do with letting others do the heavy lifting around honing solutions – whether built in house or by supplier - so they are fit for purpose. A number of participants indicated that, despite the pressing MiFID II timetable (and regardless of whether implementation is delayed or not), as an example, there was no “burning platform” at present to get a technology solution in place but that a regulator led catalyst might be required to expedite the process.

“In voice surveillance, [the industry] need some fines first to set precedent” – VP, Legal and Compliance

“[Development] depends on the next scandal” - Global Monitoring and Surveillance Head, Tier 1 Bank

9. THERE ARE PERCEIVED CHALLENGES IN IMPLEMENTING A ROBUST HOLISTIC SOLUTION IN THE SHORT TERM

Perhaps unsurprisingly in a climate of “wait and see”, firms were quick to raise challenges – real or perceived - in adopting a holistic approach to leverage the “best of man and machine”. There was a general desire to “wait for perfection” rather than taking the first steps in scoping and implementing a technology based solution. However, this sentiment belies the iterative nature of technological development which was recognised by most firms. Challenges identified included:

- Demonstrating Value – creating a compelling business case to get investment “over the line”
- Technology Constraints – integrating solutions with wider risk management tools and collaborating with data custodians
- Data Volumes and “White Noise” – the (in)ability to handle huge volumes of data and the(in)capability to filter relevant data
- Speed of Regulatory Change – keeping on top of ever changing regulation, let alone being ahead of the curve
- Vendor Capabilities – the perceived disjunct between what firms need and suppliers offer
- Language Nuances – challenges for technology and people in interpreting the huge range of dialects, languages, and trader lingo
- Skills/expertise – either now or in the future being able to find sufficient numbers of compliance analysts with appropriate skills and then retaining those staff
- Competition for talent – linked with the above, the talent war for staff and the spiralling salary costs around communications surveillance analysts

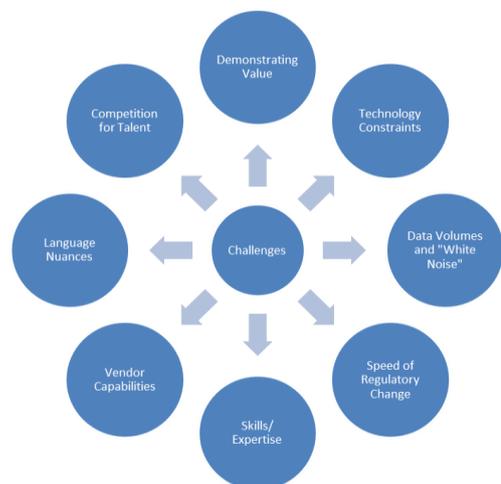


Figure 2: Frequently cited challenges to implementing a robust holistic solution

“Try finding hundreds of people outside of major global cities. The people don’t exist and it’s hard to hire in surveillance as it’s not always the most exciting job in the world” – Managing Director Compliance, Tier 2 Bank

10. COST, HOWEVER, IS NOT A DEAL BREAKER

Interestingly, cost constraints are not cited as a particular issue in exploring innovative holistic technology. Most firms have budget, with wider stakeholders and management bought in, but the hesitancy – in the absence of a “market event catalyst” - was around waiting for regulators or peers to take a lead.

Compliance spend was estimated by a number of Tier 2 participants as being between £1-3m for voice and £3-5m for holistic surveillance over the next 2-3 years. Most however were unclear what specific budget was available, suggesting either coyness or else a genuine recognition that there was a degree of “how long is a piece of string?”

CONCLUSION

The introduction of MiFID II is a key stage in the progressive evolution of enhanced market surveillance, particularly with regards to monitoring and analysing voice communications. Whilst regulations do not technically require an integrated solution to be put in place in time, some firms questioned how long it would be before holistic surveillance solutions would be required, given increasing regulatory momentum and the speed of technological change.

What is clear, however, is doing nothing is not an option and the “wait and see” approach adopted by many firms remains a high risk strategy. Currently the proactive options available to firms are:

- A pure human resource driven approach to voice surveillance, recognised by all as an imperfect solution. Growing compliance teams significantly will still not achieve 100% monitoring, scratching the surface with modest sampling, and costs will escalate rapidly
- A Big Data platform for recording and analysing trade and communications surveillance. Whilst a desirable nirvana, there is no evidence of any firm having successfully implemented such a solution
- An integrated technology based trader communication surveillance solution to meet regulatory demands, being scalable, intuitive, cost effective and empowering compliance resource to focus on key risks as they happen

It was acknowledged that holistic surveillance (incorporating the “three pillars” of trade data, electronic and voice communications) was what all firms were ultimately aiming for to meet their future regulatory commitments, and adopting a consistent industry-wide approach towards communications surveillance technology would likely lead to better acceptance of solutions by regulators, resulting in a more defensible position for all.

Whilst there is a perception held by many that current surveillance technology could be developed further, some firms are already blazing a trail, rolling out solutions –integrating voice surveillance with e-communications and trade data - in recognised high risk areas such as FX, Commodities and other benchmarked products in the UK, US and Europe. However, most firms agreed that implementation would be an iterative process starting first with these high risk areas in a specific region(s), progressively rolling solutions out further in time.

Firms acknowledged that with deadlines looming (and even with a possible delay in implementing MiFID II) the industry must do something soon and, unless the wider industry is able to agree on a technical solution soon, there will likely be a period of inaction – even well into 2016 – followed by a sudden flurry of activity and a fight for implementation resource and suppliers’ time.

Far better for firms to develop holistic approaches now from a position of control than having hands forced by regulators after risks have already arisen and senior directors potentially held liable.

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ABOUT THE AUTHOR



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RESEARCH METHODOLOGY

NICE Systems Limited (NICE) commissioned OMC Partners to examine the investment banking community's approach to communications surveillance and its response to developing an integrated, holistic approach to meet their regulatory challenges. OMC undertook 1:1 interviews with ten Tier 1 and Tier 2 Banks and Fund Managers comprising:

- BNP Paribas
- Citigroup
- Credit Suisse
- Deutsche Bank
- JP Morgan Chase
- Morgan Stanley
- Nomura
- Pimco
- UBS
- Société Générale

