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# Shape Up or Pay Up:

How Broker Dealers  
Can Keep Pace with  
Compliance

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**A Firm58 Whitepaper**

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## INTRODUCTION

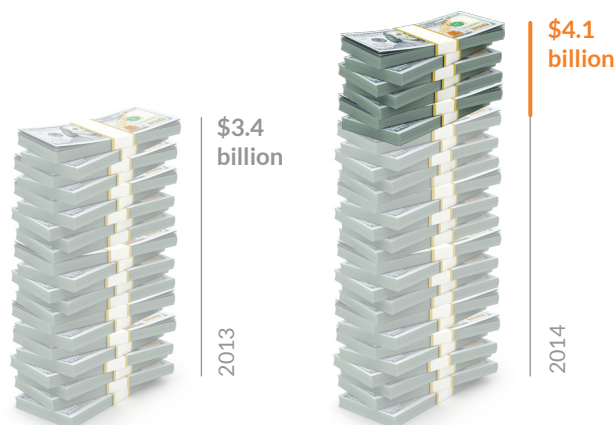
For as long as the capital markets have existed, there have been people trying to manipulate them. Throughout most of the twentieth century—decades before technology supercharged the trading world—above-board firms and regulators had to contend with occasional stock pools and short sales. Over the past fifteen years, due primarily to the emergence and embrace of electronic trading and market fragmentation, the playing field has become much more complicated.

In the last five years alone, malicious trading schemes have evolved with advances in trading platforms. For instance, spoofing (in which bad actors enter an order quote not with the intent of fulfilling it, but to manipulate the price in their favor) has long been an issue in the capital markets. The rise of sophisticated digital, algorithmic trading programs, however, has enabled malicious traders to refine their techniques. Case in point: investigators attributed the infamous May 2010 “Flash Crash”—that sent the Dow Jones industrial average down 600 points and many stocks to near \$0 value—in part due to dynamic layering, a spoofing variation that involves submitting and cancelling large order volumes to sway prices.<sup>1</sup>

These changes have forced regulatory bodies including the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) to adapt their efforts accordingly. Even now—five years since Dodd-Frank initially shook the financial services world—auditor scrutiny is still intensifying, along with regulators’ push to track order data throughout a trade’s lifecycle, from routing to execution and cancellation. Unsurprisingly, enforcement action is up: the number of individuals barred and suspended by FINRA has increased consistently since 2010. In 2014, FINRA imposed around \$135 million in fines, a 125 percent increase from 2013.<sup>2</sup>

## REGULATORY ACTION ON THE RISE

The SEC collected \$4.1 billion worth of disgorgement and penalties in 2014, compared to \$3.4 billion in 2013.



FINRA imposed a total of \$135 million in fines in 2014, up 125% since 2013 and 382% since 2008.



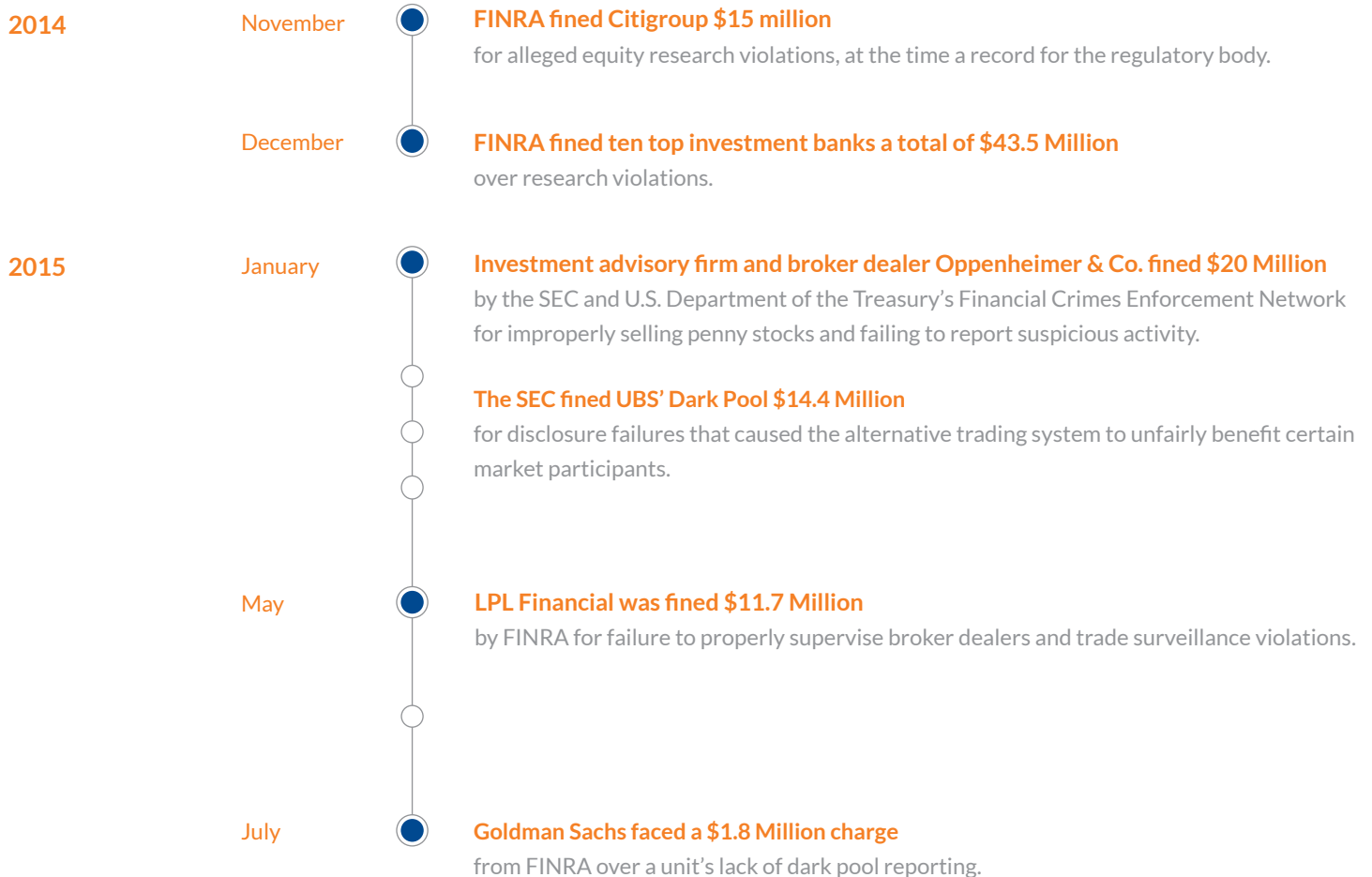
As trading schemes and regulations fluctuate, proprietary trading firms and broker dealers must take note and recalibrate their internal compliance procedures. But if the growth of industry-wide penalties is any indication, many firms have failed to improve, or at least respond to, this changing environment.

For middle market broker dealers, this issue is twofold. On one hand, some firms may suffer from an invincibility complex, feeling that their size and significance shields them from auditor criticism. Even more problematically, smaller broker dealers often settle on the belief that their budgets restrict them from investing in robust trade monitoring tools.

Neither belief could be further from the truth.

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## CATCHING RISKY BUSINESS



# COMPLIANT ON ALL FRONTS: RECOMMENDATIONS FOR PLACATING REGULATORS AND THWARTING BAD ACTORS

Contrary to middle market broker dealers' perceptions, size and resource limitations don't exempt firms from constantly improving their in-house compliance controls.

Here are five steps from technology, workflow and corporate culture perspectives that firms can and should take to ensure their surveillance and reporting procedures are up to par.

one

## Invest in technology to monitor common trade violations

Sound trade surveillance isn't limited to knowing what happened yesterday, or what will happen tomorrow. It involves analyzing trends over time in order to uncover the schemes bad actors are currently testing. Between high frequency trading and the recent proliferation of new exchanges, robust monitoring is impossible to conduct manually or using Excel spreadsheets. A 2013 study conducted by Firm58 found that more than one-third (35.7%) of broker dealers were attempting trade surveillance this way, and more than 10 percent weren't overseeing trade activity at all.<sup>3</sup>

Firms need to start treating compliance like virus software updates: always scanning for the latest threat. Fortunately, broker dealers don't need Fortune 500-sized budgets in order to adopt technology that automates the surveillance process. With the right tools, firms can scan for red flags and common trade violations daily, from wash trades and short selling to off-hours executions or spoofing. Applying technology to trade monitoring ensures that important issues aren't skimmed over, and helps create a centralized repository for incident records and resolutions (which can prove invaluable during audits).

two

## Keep updated internal rule lists for more efficient surveillance

Implementing a solution that automates parts of the compliance process is one step toward safeguarding a brokerage and its clients. Regardless of the tools a firm has in its arsenal, detecting truly malicious activity can still feel like finding a needle in a haystack. Beyond monitoring for the same red flags FINRA and the SEC regulate, broker dealers should also track issues that are exclusive to their client base and traders.

Compliance departments must make it a point to maintain up-to-date lists of firm-specific rules that can be used to expedite surveillance. These lists might include securities that a firm doesn't want trading partners to hold, intraday activity limits, or other behaviors that would put the business in a precarious spot in terms of regulators or revenue. Depending on the technology a firm has in place, certain surveillance platforms can be customized with these rules to help cut through the noise and home in on suspicious dealings.

three

### **Verify whether or not red flags disturbed the market**

Identifying red flags whenever they appear is critical for sustaining broker dealer compliance; every year, FINRA fines firms hundreds of thousands of dollars for failing to adequately follow up on questionable issues. That said, not all red flags are created equal. Firms frequently strain already limited hours and resources investigating “false positives,” issues that appear unusual on the surface but have no meaningful impact on market prices or trading activity.

Broker dealers need to develop formal processes, and gather relevant tools, for evaluating the effects of each detected red flag. This is another procedure that shouldn’t be left to human confirmation alone. Given the volume and velocity of daily trades, compliance staff may need weeks to follow up on red flags manually (at which point the damage could already be done).

four

### **Manage internal codes of conduct**

Technology can go a long way toward bolstering broker dealer compliance, but it isn’t the only solution. Ultimately, a firm’s culture sets the tone for individual trader behaviors and company-wide ethics; the impetus is on executives and other business leaders to foster a culture that prioritizes compliance. With broker dealers of all sizes susceptible to regulator and auditor scrutiny, a firm’s longevity depends on how proactive it is about following the rules.

On a practical level, firms should develop and promote formal codes of conduct among all staff members. At a minimum, broker dealers should regularly communicate the importance of always taking a closer look at trading activity, and encourage employees to notify the compliance team whenever unusual behavior is detected. Some firms might consider having employees “put skin in the game” by signing written agreements to uphold certain practices, or disclose information about their personal backgrounds.

five

### **Document your methods, and the rationale behind them**

Having a literal or digital paper trail that demonstrates the compliance processes a firm has in place, or course of action taken in response to specific red flags, is only part of the documentation broker dealer back offices need. Despite how strict capital markets regulations can be, they still leave ample room for interpretation. It’s just as important to keep detailed records that explain each step that goes into internal compliance procedures, and why a certain strategy was taken (or skipped), in order to satisfy auditors.

## CONCLUSION

Capital markets compliance is not exclusive to broker dealers of a particular size or security. It's a facet of doing business that firms and regulators both need to approach with an attitude of continuous improvement.

Sooner rather than later, middle market firms need to shake the notion that they shouldn't (or are unable to) invest in advanced technology systems to strengthen internal compliance practices. Innovations in software development have eliminated historic barriers to technology adoption so that broker dealers don't need Wall Street-sized budgets to access modern digital solutions. Whether a firm has a three-person compliance team or a CEO that moonlights as the ad hoc chief compliance officer, there are tools available that can drive significant returns in the form of increased staff efficiency, better client service and satisfied regulatory demands.

Technology, despite its benefits, isn't the only key to maintaining a compliant business. Ethical trading, acute surveillance and transparency are broad principles that must become part of a firm's ethos, whether they're enforced through internal codes of conduct, staff onboarding or training. Dashboards, applications and other IT solutions are only as effective as the employees using them.

The past five years proved how fluid capital markets compliance can be. Trading schemes have and will continue to morph right alongside trading technologies and regulations. There is little broker dealers can do to slow the industry's rate of change, but refusing to transform with it is not an option. What separates the successful, enduring firm is its willingness to keep up.

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## ABOUT FIRM58

Firm58 helps capital markets firms become more efficient by leveraging the back office for post-trade process improvements.

With our solutions, businesses benefit from lower staffing requirements, better compliance and simplified processes for fees and commissions.

To learn more about Firm58, visit our website at [\*\*firm58.com\*\*](https://firm58.com).