Keeping Rogue Traders At Bay

Law360, New York (October 04, 2011, 4:27 PM ET) -- On Sept. 16, 2011, Kweku Adoboli, a native of Ghana and UBS AG employee, was charged with fraud arising out of unauthorized trading. UBS estimates that Adoboli’s rogue trading continued for three years and caused it to incur losses of $2.3 billion.

Banks, lawyers and other industry specialists are all posing the same question: Given UBS’ sophisticated risk procedures, how did Adoboli’s rogue trading go undetected for so long? And what lessons can the industry learn?

A Little Background

Adoboli joined UBS’ London investment banking division as an analyst in 2003 after graduating, with honors, from the University of Nottingham in England. Adoboli served a so-called “back-office” function: He entered and confirmed trades, handled accounting issues and transmitted payments. In September 2006, he began trading exchange-traded funds (ETFs) on UBS’ “Delta-One” trading desk.

The trading involves two steps. First, a client initiates a trade in an ETF that bets on the direction of a group of stocks, such as European or U.S. stocks. The trader executes the trade and acquires the basket for UBS. Second, the trader hedges the trade by creating a mirror trade of the bet. Adoboli skipped the second step and made unauthorized unhedged trades on the direction of European and U.S. stock markets using UBS funds. To conceal the unhedged bets, Adoboli created a fake mirror trading book with off-setting — but unexecuted — ETF trades. Adoboli’s motive is unclear, but the fictitious trades were made to avoid scrutiny of the unauthorized bets.

Adoboli employed two strategies to avoid detection. First, he took advantage of a European loophole that does not require trade confirmations for ETFs. Second, because his fake trades did not involve the movement of cash into or out of UBS to settle gains or losses, UBS’s internal risk control processes were not triggered. Adoboli traded with other UBS trading desks or outside financial institutions.

UBS suspected Adoboli of fraud in July, but did not question him until September. It is unclear why UBS waited. Adoboli admitted to making the unauthorized trades.
UBS claims that none of its clients suffered any losses. It suspended the activities of other traders at the Delta-One desk, pending the outcome of its investigation. Adoboli’s direct supervisor, John Hughes, resigned the day after being notified of Adoboli’s fraudulent activities.

**Potential Warning Signs of Rogue Traders**

The circumstances surrounding Adoboli’s activities share traits with other rogue traders, and financial institutions should closely monitor these potential warning signs.

*Moves from Back-Office Services to Front-Office Trading Desks*

A front-office trader who formerly worked in the back office should be viewed as a risk. Back-office employees gain knowledge about the proper procedures for documenting and accounting for authorized trades, and, more importantly, how to circumvent these procedures without drawing attention.

Adoboli’s back-office experience likely taught him about the European market loophole for the nondocumentation of ETF trades, UBS’ treatment of internal trades and its trades with external financial institutions. His knowledge was critical for concealing unhedged trades.

Two other notable rogue traders also relied on their back-office experience to commit fraud: Nick Leeson and Jerome Kerviel. Leeson was a 28-year-old trader for Barings Bank, who covered up his unauthorized trading and losses in the Japanese stock exchange by using an error account he knew of from his experience settling trades. Barings declared bankruptcy as a result of Leeson’s trading.

Kerviel devised a scam at Société Générale SA in 2008 that involved fictitious transactions that resulted in $7.2 billion in losses. Kerviel’s scam likewise used his knowledge of back-office practices to delete the fake trades prior to scheduled inspection dates. After the inspection date passed, he reentered the fake trade and started the process over.

After Kerviel’s rogue trades were publicized, many banks, including Société Générale and HSBC Holdings PLC, prohibited shifting back-office employees to front-office client-trading desks. UBS, however, did not. To prevent the likelihood of future rogue traders, more banks should institute a policy that prohibits using back-office employees at trading desks.

*Delta-One Desks*

Delta-One desks pose a risk for unauthorized trading, namely, that a trader will make large bets on future stock market moves, but fail to purchase the required off-setting hedge.

Adoboli and Kerviel failed to purchase off-setting hedges and created fake transactions that did not involve cash flowing in or out of the bank, or did not require confirmations. These fake transactions gave the false appearance of fully hedged Delta-One transactions.

Banks should take additional steps to monitor Delta-One traders to ensure that off-setting securities are actually purchased to hedge the risks associated with the derivatives purchased in the first step of Delta-One transactions.
Lax Supervision/Management

Inadequate supervision and management of traders should also be considered a risk for facilitating rogue trades. Multinational banks need to be crystal clear about what regional office is ultimately responsible for governing a trader’s activities.

There is evidence that UBS inadequately supervised Adoboli. John Hughes, Adoboli’s supervisor, resigned the day after discovering the details of his alleged fraud. One factor that possibly contributed to this lax supervision is the unusual organizational structure of UBS’ London investment banking operations.

Ordinarily, foreign banks in the U.K. are set up in two possible ways. Some foreign banks, such as Deutsche Bank AG, have branches in London, but are primarily regulated by foreign regulators from their own country. Alternatively, Banco Santander SA is set up as a subsidiary in London and regulated by the U.K.’s financial regulator, Financial Services Authority.

UBS’ London investment banking operations are set up as both a subsidiary and a branch, so its operations are regulated by both Swiss and U.K. regulators. This unclear regulatory structure may have created ambiguity about what division of UBS was ultimately responsible for the Delta-One desk and Adoboli. The trading operations in London and Switzerland may have thought that the other was primarily responsible for supervising Adoboli. Neither office may have monitored his activities.

A similar ambiguity occurred with John Rusnack, who lost $691 million for Allied Irish Banks PLC (AIB) by using fictitious options to cover trading losses. Rusnack traded currency options at AIB’s subsidiary in Baltimore and reported directly to a manager that was appointed by AIB and not by the subsidiary. It was unclear whether AIB or the subsidiary was responsible for Rusnack’s activities, and both parties assumed that the other one was directly responsible. This uncertainty contributed to the failure to discover Rusnack’s losses.

Multinational banks with different regional trading offices should have clear lines of responsibility for managing their employees at different offices.

Insufficient Risk Control

UBS may have had insufficient risk management and control. Adoboli’s fraudulent trades allegedly date back to 2008, and UBS’ risk officials did not become suspicious until July 2011. Furthermore, the risk officials waited until mid-September to question Adoboli about his trades. This three-month delay likely magnified UBS’ losses.

Inadequate risk management and control are a common thread among the companies that suffered from rogue traders. For examples, Kerviel engaged in fraudulent transactions for three years before suspicions were raised about his activities, and he was permitted to trade for several more months, despite reports from risk management personnel that his explanations for trading anomalies were incoherent.
UBS claims that its risk-control systems were revamped after the $50 billion losses from mortgage-backed securities in 2008 and 2009. These changes, however, redressed compliance flaws that allowed UBS to concentrate its risk in one class of fixed-income securities, and not on the risk that a former back-office employee may make fraudulent trades.

UBS's risk-control systems may have been inadequate, and all multinational banks should take heed and upgrade their risk-management controls to ensure that rogue traders like Adoboli do not strike again.

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