Guarding the Guards

By Stephen J Nelson, The Nelson Law Firm, LLC

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Last week's news was dominated by Jérôme Kerviel, a mid-level trader that caused a $7.2 billion trading loss for Société Générale. When Société Générale tried to unload Mr. Kerviel's positions last Monday, a global panic spread through financial markets, the Fed lowered interest rates by one of the largest amounts in its history, and estimates of the financial damage are still rolling in.

It is only natural to wonder how the controls at a huge multi-national bank of the stature and sophistication of Société Générale could have permitted Mr. Kerviel to build positions of this size. And, we can expect that regulators throughout the world will be thinking about how to design controls that will prevent a repeat of this unfortunate episode. That is, after all, the job of a regulator, and the politicians who have oversight responsibilities for regulators will expect some answers. We, the voters, have oversight of politicians and will demand that something be done. The politician who fails to hear that clarion call can expect to be punished severely at the next election. This is the way democracy works.

The Kerviel episode brings to mind the case of another employee of Société Générale, the Cleveland-broker Frank D. Gruttadauria, who received a seven-year sentence for securities fraud in 2004 and as far as I know, is still a guest at a federally-managed penal institution. Mr. Gruttadauria's conduct, equally incredible, led to some of the most draconian and expensive regulation of U.S. broker-dealers that has ever been conceived.

Mr. Gruttadauria was the branch manager of Cowen's Cleveland office when Société Générale purchased Cowen in 1998. Before joining Cowen in 1989, he had been a registered representative for three other broker-dealers. Sometime in 1987, Mr.Gruttadauria found a way to circumvent the controls at Lehman Brothers to steal money out of customer accounts. His strategy worked so well that over a period of 15 years, he managed to purloin more than $100 million from over 60 customers at five leading brokerage firms. In 2002, Mr. Gruttadauria fled, leaving a note to the FBI describing what he had done. In more than 60 customer accounts valued at over $200 million, less than $2 million remained. The regulatory response to Gruttadauria's fraud is enshrined in FINRA Rules 3010, 3012 and 3013, which deal with something called "Supervisory Controls."

It is important to understand the difference between Supervisory Controls and Written Supervisory Procedures. FINRA's Rules require firms to institute written supervisory procedures for supervisors to follow to ensure compliance with FINRA's Rules and federal and state securities laws. Supervisory Controls, on the other hand, required each supervisor to be supervised by another independent supervisor, to make sure that the supervised supervisor is following the written supervisory procedures. It requires firms to hire guards to guard the guards.

This is not a new idea. The paranoid Tiberius Caesar established the Praetorian Guard to make sure than none of the Empire's local governors were contemplating his overthrow. Taking a page from that history, the legendary two-gun Chief Parker cleaned up the LAPD with the institution of an Internal Affairs Division. Few police departments of any size these days can afford to be without one. Nonetheless, the fact remains that supervisory controls are an expensive way to ensure honest conduct. Moreover, they are not fool-proof, which is the lesson learned from Tiberius and the LAPD.

For small firms, compliance with Supervisory Control procedures is often impossible. Where the firm is owned by one iron-fisted general, who is also the firm's head trader, there simply isn't anyone else at the firm who can impose meaningful supervisory controls. For larger firms, Supervisory Controls mean that supervisors do double duty – following their own procedures, as well as looking over some other supervisors' shoulders.

The Supervisory Controls that have followed in the wake of the Gruttadauria scandal have been accompanied by a ramping up of compliance procedures. In theory, a firm's written supervisory procedures are supposed to be tailored to a firm's business. In a small shop, where everyone knows everyone else's business, social pressure, bolstered by the gimlet eye and sharp tongue of an autocratic head trader, once served as an adequate substitute for complex procedures. Since Gruttadauria, however, FINRA and SEC compliance examiners no longer accept informal reviews of trading runs as sufficient to ensure trading desk compliance. Instead, multiple logs and reports are generated that must be reviewed and signed, and then countersigned by a second supervisor. As a result, written supervisory procedures are much more detailed and complex than was generally the case a few years ago, and there is a convergence of large and small firm compliance procedures and supervisory practices.

Of course, supervisors in the brokerage industry have more to do than review reports and sign logs. There is also the matter of dealing with customers and markets, as well as promoting the firm's business. So, increasingly, compliance reviews are delegated to compliance professionals, who have the job of alerting the supervisor when something is not quite right on the desk. There are very few trading desks these days without a dedicated compliance professional assigned to them. Smaller firms often cannot afford this compliance layering; as a result, there are fewer small firms and that trend can be expected to continue.

I leave it to others to dispute whether a compliance professional is more likely to spot miscreant behavior by a trader than a veteran trader reviewing trading runs and listening to the flow of conversation on the desk. Instead, I will assume for the sake of argument that the web of controls that have flowed from Gruttadauria's misdeeds make it less likely that someone else will be able to steal from customers, at least in the incredible amounts achieved in that infamous case.

I also have no complaints about the democratic process, as the alternatives are depressing. So, I accept the fact that more regulation is inevitable and necessary. Mr. Kerviel brought the world's markets to their knees. Something must be done to make that sort of thing more difficult.

Yet, I wonder if there isn't a better way than imposing another layer of controls. Is the Praetorian Guard the only answer? Is the result worth its cost?

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