KEY POINTS

- To prevent unauthorised trading incidents in the future, banks will need to ensure that operational risk management is embedded throughout their business and given appropriate prioritisation in terms of resources and management.
- The FSA's recent action against UBS shows that the regulator will view past incidences of similar misconduct as a serious factor when determining the appropriate financial penalty.
- FINMA's investigation went further than the FSA who made no specific findings on the culture at UBS.

Feature

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FSA v UBS: will big fines change banks' attitudes to risk management?

The question of how banks and other financial institutions adequately guard against risk is on the agenda once again, following the discovery of a high value unauthorised trading event at the Swiss Investment bank UBS AG.

In the aftermath of the much publicised conviction of the former UBS trader Kweku Adoboli for fraudulent trading, on 25 November 2012 the FSA fined UBS AG (UBS) £29.7m for breaches of Principles 3 and 2 of the FSA's Principles for Business. This followed the conclusion of similar enforcement action against the bank brought by FINMA, the FSA's Swiss counterpart, just a few days earlier. Both regulators found that UBS' risk management systems and controls were not fit for purpose, creating an environment in which dangerously large off-book positions could be concealed.

The financial penalty levied by the FSA, calculated at 15% of the offending desk's profits and the third largest ever imposed, is consistent with the regulator's increasing emphasis on risk management systems and control as one part of its credible enforcement agenda. However, ensuring that firms have proper risk management controls in place has been a key concern of the FSA since (at least) March 2008. Moreover, in 2009 UBS was given what was at the time the largest ever fine imposed by the FSA for having inadequate systems in place, following a similar unauthorised trading incident in the bank's private banking division. It remains to be seen whether enforcement action against banks and other financial institutions is capable of fostering corporate cultures which place greater emphasis on compliance and risk management.

The action taken by the FSA and FINMA followed the discovery in September 2011 of an incident of fraudulent trading for which Adoboli was responsible. He worked on the Exchange Traded Funds desk in the Global Synthetic Equities (GSE) department at the UBS London branch. Between October 2008 and September 2011, he executed a series of unauthorised trades which, when discovered, resulted in a loss to the bank of over £1.5bn. Adoboli disguised positions which were in excess of his desk's net delta limits by using a number of different mechanisms, including an off-book account ("the umbrella account") from which profits and losses were drip fed into the desk's legitimate systems. Embarrassingly for UBS, it later transpired that three of Adoboli's colleagues working on the desk were aware of the existence of the umbrella. Adoboli was arrested by the City of London Police and, following a trial, on 20 November 2012 was convicted of two counts of fraud by abuse of position. He was sentenced to seven years imprisonment.

FSA ACTION

Following Adoboli's arrest, UBS instructed an external advisory body to prepare an independent report into risk controls at the bank. The report identified a number of deficiencies, in the front, middle and back offices which the FSA found constituted breaches of Principles 3 and 2. These included:

- IT systems designed to assist in identifying rogue trading were inadequate.
- Significant deficiencies existed in the trade capture and processing system. The system allowed trades to be booked to an internal counterparty without sufficient details, there were no effective methods in place to detect trades at material off-market prices and there was a lack of integration between systems.
- The Operations Division did not properly understand their role. Rather than challenging the traders where appropriate they perceived their function as being to assist traders in reconciling trades, simply accepting their explanations for breaks (a trade which would not reconcile between one system and another, or between one counterparty and another).
- There was inadequate front office supervision. Following the transfer of the ETF desk to the GSE division, oversight for the ETF desk was assigned to a senior trader in New York. When the Operations Division reported problems with reconciling external futures trades which had been late booked by Adoboli, the desk's supervisor accepted Adoboli's explanations without challenge.
- Where traders on the desk (including Adoboli) breached the risk limits set for their desk, they were not routinely disciplined. On one occasion Adoboli was disciplined, but not before being congratulated for the profit he had made.
- Between 2010 and the first and second quarters of 2011, the net revenue recorded by the ETF desk increased significantly, several times greater than the increase in the desk's risk limits. No explanation for this was sought.
- Profit and loss suspensions to the value of $1.6bn were requested by Adoboli during the course of August 2011 and were accepted without challenge or escalation.

PREVIOUS REGULATORY ACTION

Unfortunately for UBS, the bank had been subject to similar enforcement action in 2009, where the FSA had imposed a fine of £8m for similar breaches. This action followed another unauthorised trading incident, this time in the London branch's private banking division. A number of traders had engaged in foreign exchange transactions using client money without authorisation. UBS' investigation following the 2009 event revealed a number of failings in the bank's risk management systems at least as they applied to its private banking arm. The traders responsible, Sachin Karpe, Jaspreet Singh Ahuja, Laila Karan and Andrew Cumming were fined £1,250,000, £150,000,

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£75,000 and £35,000 respectively and made subject to prohibition orders. The compliance failures at the bank also resulted in the FSA's action against the CEO of UBS Wealth Management, John Pottage, for failing to assess and remedy compliance failures in good time following his appointment. In a major setback for the regulator, that decision was overturned following reference to the Upper Tribunal (See "*The buck stops where? Regulatory Action against senior managers post FSA v John Pottage*" [2012] 8 JIBFL 490).

FINMA ACTION

In tandem with the FSA, FINMA, the Swiss regulator, commenced its own investigation into the unlawful trading incident. It subsequently announced it would take enforcement action against the bank. On 21 November 2012, FINMA published its findings, concluding that serious failings existed in UBS' risk management and control environment. FINMA's conclusions were similarly based on the internal report commissioned by UBS following the revelation of Adoboli's off-book trades. Its findings and conclusions largely mirrored those of the FSA, although it did go further than the FSA in some respects. Specifically, FINMA criticised UBS' failure to formalise and communicate the ETF desk's reporting lines, particularly following the transfer of the desk to GSE. It also explicitly censured the bank's reward and recognition systems, noting that despite several breaches of the bank's compliance policies relating to personal account dealing and spread betting, and repeated failures to comply with the bank's control standards, Adoboli was nonetheless highly remunerated, thereby incentivising his risk-seeking behaviour. This went further than the FSA who made no specific findings on the culture at UBS (although did make some oblique references, including to a suggestion that as those working in the middle office aspired to front office roles, they were more inclined to facilitate rather than challenge traders).

PENALTIES IMPOSED

The FSA imposed a penalty of £29.7m, calculated with reference to the regulator's Decision Procedures and Penalties Manual. Importantly, the FSA viewed UBS' previous disciplinary record (the 2009 action) as an aggravating factor. They noted that, whilst the matter was distinct, the investigation into the 2009 unauthorised trading incident had identified failings in the bank's supervision over customer-facing employees who were not challenged appropriately. Moreover, clear warning signs were not acted upon. FINMA prohibited UBS from engaging in any new business activities without prior authorisation from the Swiss regulator.

LESSONS TO BE LEARNT?

The steps which the FSA expects firms to take to mitigate the risk of unauthorised trading have been clear since (at least) early 2008. Following the revelation of a massive unauthorised trading event at Societe Generale the FSA, in its March 2008 issue of Market Watch, provided the market with clear advice on measures to adopt to minimise the risk of an unauthorised trading event. These included:

- Monitoring whether a trader had a high number of cancelled or amended trades.
- Considering whether those exercising control functions had sufficient understanding, skill and authority to challenge front office staff effectively when agreed parameters for activity are breached or when something else suspicious takes place.
- Enforcing risk limits with disciplinary action where appropriate.
- Understanding where the desk's profit and loss is coming from.
- Having proper systems to reconcile trades, and to confirm internal trades.

The fallout from Adoboli's unlawful trading is a clear reminder for firms, if one were needed, of the importance of having those systems in place, but there are also other lessons to learn.

First, firms should have systems in place which reflect a proactive and proportionate response to risk across the business, eg ensuring that the middle and back office functions are adequately resourced and sufficiently trained. Firms need to balance the generation of profit with adequate risk management.

Secondly, the FSA's action against the Swiss bank shows that where red flags are raised (in UBS' case following the 2009 unauthorised trading incident), firms should take care to conduct a careful review of control and governance structures across all business areas in order to identify whether seemingly isolated failings are in fact examples of a more systemic compliance risk. The FSA's recent action against UBS shows that the regulator will view past incidences of similar misconduct as a serious aggravating factor when determining the appropriate financial penalty.

Thirdly, the *Pottage* case (brought in the aftermath of the 2009 unauthorised trading incident) demonstrates that where failings exist within a regulated business, those exercising a Significant Influence Function must take steps to remedy them in good time or face action from the regulator themselves. Although Mr Pottage successfully appealed the FSA's decision to take enforcement action against him in the Upper Tribunal, this does not mean that the FSA will be deterred from looking to make senior executives culpable for systems and controls failings as this is an important aspect of its credible deterrence agenda.

A SHIFT IN CULTURE

A bigger challenge for the FSA will be to use its enforcement powers to promote a real change in banks' risk culture. To prevent unauthorised trading incidents in the future, banks will need to ensure that operational risk management is embedded throughout their business and given appropriate prioritisation in terms of resources and management. They will also need to ensure that their remuneration policies do not incentivise risk-taking behaviour and that individuals who breach internal compliance policies are dealt with effectively through disciplinary procedures.

The issue remains as to whether a £29m fine in the UBS case will be sufficient to drive home the message that the risk culture in banks needs to change. UBS has now had two unauthorised trading incidents in the space of three years. The question is whether even a multi-million pound fine will prevent a third. Equally, time will tell if this fine acts as the impetus for other banks to reconsider their approach to dealing with risk management. ■