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In this month's HORIZON:

- **Binaries And Digitals** – The **BAD** boys are back, and so it would seem **BAD** behaviour.
- **Securities Lending** – Dumb Money vs Transparency – who will win?

Binaries And Digitals

It seems that traders can't help being tempted by big pay-offs. Whether it's an index expiry, a digital FX contract, triggering a stop-loss or to circumvent a CDS auction, where there's a way, it seems there's often a will! Certain types of events are now well recognised by control staff, and one would hope **Transaction Monitoring** teams set their clocks by index expiries!

The gamma around a digital close to expiry has the potential to be vast. Where control staff may find monitoring trading activity challenging is in identifying legitimate hedging activity, versus trading activity designed to defend or attack barriers, triggers or levels. A further challenge is the "knock-out" effect on Market Risk Monitoring systems[1], meaning there can be a pragmatic need to manually adjust reporting for products, all at a time when they need to be monitored most closely. As the finding against the trader Neil Philips[2] shows, often the evidence for intended manipulation lies in concurrent communication records, rather than based on trading activity alone.

Traders don't need the outcome of a derivative product to engender a windfall. From a customer perspective, the group that should be afforded the highest level of care can be the most vulnerable. This is particularly where the controls designed to protect them are used and abused to disadvantage them. An example of this kind of activity would be where retail traders find themselves closed out of positions due to the triggering of **stop-loss** orders. A further layer of abuse which is fertile ground for disputes is where stop losses are triggered out of hours, or where the transparency of a market is low – think Cryptocurrency.

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[1] The sheer size of exposures calculated by risk systems literally takes readings off the scale https://bookdown.org/maxime_debellefroid/MyBook/classic-options.html#digital-options

[2] Neil Philips was convicted of commodities fraud over allegations he deliberately targeted an FX barrier Option on Boxing Day 2017 https://www.justice.gov/usao-sdny/pr/statement-us-attorney-damian-williams-conviction-neil-phillips

The examples above should be well recognised by control staff, but it does not hurt to refresh memories, particularly as the year draws to a close, indeed a year which has been difficult for Front Office staff, and where the threat of reduced bonuses are being speculated on in the press[3].

More challenging are occasions when the pricing windows or mechanisms are circumvented, rendering even the most prepared Transaction Monitoring team at a disadvantage. What on earth are we talking about?

Nicolas Corry, SKADI's MD, and a former head of CB trading, explains:

"It can be tempting for control staff to look at the problem of market manipulation head on. i.e. concentrating on specific trading activity at the time of an event, such as an expiry. There may be a lack of awareness of methods traders will utilise to prevent a trigger from occurring. The Credit Default Swap (CDS) market is one such area of risk. When a credit event has been determined and the decision is made to sell debt linked to the payout of the CDS, the market expects an auction for the debt to take place. There have been instances where the auction has not occurred as the Debt Servicer expected to manage the auction received an offer for the debt which was too good to refuse. The result, no payment is made on CDS contracts."

Where instruments are constituents of indices, **surveillance** is harder still. One such instance was the bid for debt by Cannae Portfolio Advisers in the early part of this year. CDS payouts tied to tranches of debt, which were references for the CMBX 6 index[4], were avoided. The Cannae bid at US$160m, was more than US$40m higher than any other bids submitted for the same debt. What makes CDS such a poignant product of risk for Wholesale Financial Institutions is that the market for CDS can be much larger than the market for the underlying debt which CDS contracts are hedging. Further it tends to be sell-side institutions which are net sellers of CDS. The amount spent on debt can be relatively low compared with the exposure institutions have to short CDS positions.

In SKADI's Emerging Risk Outlook for 2024, we predicted that increased insolvencies would be a theme for the coming year. Recent reporting shows that they have since grown to be at their highest level since 2009[5]. Rising insolvencies will in turn lead to rising numbers of Credit Events, which will trigger increased numbers of CDS auctions (which can then be circumvented).

For control staff at Wholesale Financial firms we feel the following areas should be considered:

- Transaction Monitoring: What line of sight do Transaction Monitoring teams have over trading activity in products with digital and barrier characteristics? What line of sight do they have over constituents of Indices, particularly Index CDS where trading activity could result in a binary outcome, or prevent one?

[3] https://www.fnlondon.com/articles/doughnuts-loom-bankers-brace-for-brutal-bonus-season-20231030
[4] https://www.wsj.com/finance/investing/carl-icahn-bet-on-the-big-short-2-0-now-he-says-the-game-was-rigged-1ce090aa
[5] https://www.cityam.com/insolvencies-at-highest-levels-since-2009-but-which-sectors-are-the-worst-hit/

- Reputational Risk: Control Staff should assess the risk of potential conflicts of interest as well as other consequences such as reputational risk impact, where desks have written CDS protection, and intend to trade in debt following the determination of a credit event.

Securities Lending

Dumb Money, the film charting the thrilling ride of the GameStop short squeeze had its UK release last month. The squeeze was brought about by Redditors sensing that the number of borrowed shares in circulation exceeded the total shares in issue[6]. Collective action in early 2021 (remember Democratisation of Finance?) by an army of retail traders triggered a sharp short-squeeze that threatened to overcome a number of large institutional players.

October 2023 saw the SEC adopt the final rules on short selling information reporting, Rule 10c-1a. This aims to increase **transparency** into short-sale related data as well as the securities lending market as a whole. It was slightly watered down from the original draft rule and, much to the relief of securities lending operations teams, the 15-minute reporting rule was dropped and replaced with end-of-day reporting. Go-live for this reporting change is set for 2025. This move seems to recognise the need to tighten up controls in the stock loan market, and prevent incidences of **market manipulation**.

The implementation, however, will not be without its challenges. Infrastructure will need to be reviewed to assess whether requirements can be met to report required information[7] to FINRA, the Registered National Securities Association (RNSA). Some loan terms will be made public, others will only be reported to the RNSA. With the public dissemination of lending rates, we foresee that the Rule could have implications on how financial institutions are judged on treating customers fairly.

Damian Taylor, SKADI Director, ex-head of trading and hedge fund manager writes:

"With rates now in the public domain (albeit with a 20-day delay) clients will be able to compare rates they are receiving with those of other market participants. It is hard at this stage to foresee what unexpected consequences arising from the Rule's introduction will be. Some suggested ones could be ramifications for borrow rates being treated as submissions. Tensions arising from market participants not understanding the nature of certain pools of lending and their impact on cost. An example of this could be unstable index arbitrage inventory, compared with restricted borrow reserved for participants in a structured transaction."

Control staff may wish to consider the following:

- Trade/Transaction Reporting: With a number of loan terms to be reported publicly and privately, within an initial long timeframe (20 days), it is worth noting that proposals had been for a 15-minute requirement. Control Staff

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[6] https://www.reuters.com/article/us-retail-trading-shortselling-explainer-idUSKBN2AI2DD
[7] https://www.sec.gov/files/34-98737-fact-sheet.pdf

should be open to the possibility of timeframes changing at future points in time.

- Market Conformity Testing: Control staff should be asking whether Stock Loan is captured within the existing Market Conformity Testing framework?

- Independent Price Verification (IPV): One of the benefits of the rule is the ability to verify and test model assumptions for stock borrow. Control staff should be considering whether IPV teams and Market Risk Managers have identified and are ready to utilise the available new data set.

Previous **Horizon** editions can be found [here]

The SKADI Podcast – "Harnessing Corporate Investigations to drive Organisational Transformation" with Niral Kalaria

Niral shares his insights on Transformations drawn from his career as the Chief Ethics Officer of DWS, Global Head of Group Audit Investigations for Deutsche Bank and a former Attorney with the SEC.

In this fascinating episode Niral explains how Corporate Investigations can be harnessed to bring about organisational change. How organisations can gain an ROI - "return on investigations"! and analyse the lessons learned.

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