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COMPLIANCE **REIMAGINED**

# THE TECHNOLOGY GAP

## When Regulators have Better Tools than Compliance

Mphasis

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# INTRODUCTION

Historically, regulation has lagged behind the technological innovations of the financial services marketplace. For example, black box trading and the problems associated with it pre-date the adoption of Regulations ATS and SCI by years. The financial markets continue to evolve and modernize and so too have the tools regulators are using to police them. However, the tools used by compliance officers, as well as the confidence in their efficiency, are not evolving quickly enough. Regulators have not only grasped the importance of Big Data; they have embraced it with initiatives that are designed to harness the power of Big Data to more effectively police the marketplace. Conversely, Big Data has barely begun to enter the lexicon of technology solutions available to compliance officers.

# THE IMPACT OF REGULATORS' TECHNOLOGY INITIATIVES

The Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have spent the past two years proudly announcing their use of technology to provide more efficient oversight. In October 2014, Carlo DiFlorio, FINRA's Chief Risk Officer and Head of Strategy, emphasized that FINRA has a robust equity and options surveillance program in place that has never been more focused or effective at identifying manipulative or disruptive electronic trading activity[1]. Proof of that robustness can be found by looking at the statistics published on FINRA's website, which shows a significant increase in enforcement actions. For example, in 2013, FINRA barred 135 more and suspended 221 more registered representatives respectively than it did in 2012[2]. Likewise, the SEC reported that in 2014, new investigative approaches and innovative use of data and analytical tools contributed to a record 755 enforcement actions with orders totaling $4.16 billion in disgorgement and penalties[3].

# FINRA – CARDS AND COMMITMENT

FINRA is taking advantage of modern technological resources – especially in areas of data risk analytics and surveillance – that are changing the way FINRA examines firms and oversees markets[4].

These resources include the proposed Comprehensive Automated Risk Data System (CARDS), which is envisioned as a tool that will enable FINRA to:

- Identify patterns of transactions that indicate bad behavior on the part of a particular broker-dealer, branch office, or registered representative
- Monitor more effectively for problem areas such as pump and dump schemes, suitability, churning, mutual fund switching, and concentrations of high risk securities
- Respond more quickly to stop those activities before more investors are harmed[5]

By moving ahead with its CARDS proposal and other initiatives, FINRA is taking advantage of modern technological resources such as data, risk analytics and surveillance. This way FINRA is able to examine firms and oversee markets in a dramatically different way.

1.Carlo DiFlorio, Remarks at NSCP Conference, October 20, 2014. | 2.See http://www.finra.org/Newsroom/Statistics/ | 3. Press Release, SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First Ever Cases (Oct. 16, 2014). | 4. Carlo DiFlorio, Remarks at NSCP Conference, October 20, 2014. | 5.Id.

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# THE SEC'S MIDAS TOUCH AND THE CHANGING FACE OF REGULATION

In 2012, the SEC announced the implementation of the Market Information Data Analytics System (MIDAS) as its tool to handle the "downpour of data" generated by markets[6]. MIDAS is used to capture detailed information about trades executed on and off national exchanges. Referred to by the SEC as "the world's greatest data sandbox," MIDAS will be used by SEC's quantitative analysts to examine:

- The speed of quotes and subsequent cancellations — in today's market, where fractions of a second can be critical, this could give [the SEC] a clearer picture of the potential effects of rules like those requiring quotes to have a minimum time-in-force.
- The full depth of book for liquid as well as illiquid stocks — this could help [the SEC] understand how overall market depth is affected, as top-of-book spreads narrow or widen, and the potential effects of a tick size pilot and other rule changes.
- Intraday volatility — analysis of volatility within a trading day could allow [the SEC] to better understand anomalous trading and extraordinary intraday spikes as well as monitor the impact of rules that limit stock volatility once fully implemented[7].

Likewise, as the agency that is responsible for the Consolidated Audit Trail (CAT), which will track orders across multiple trading platforms from inception as they move through the market and through to execution. The SEC plans to vigorously utilize the data from MIDAS and CAT to enhance its regulation of the markets. The nexus between the two, as stated by Elisse Walter, is that CAT has the potential to expand the SEC's ability to analyze market structure and behavior even further than MIDAS while improving the SEC's ability to reconstruct and pinpoint the source of trading irregularities and investigate suspicious activity[8].

6. Elisse Walter, Harnessing Tomorrow's Technology for Today's Investors and Markets, Feb. 19, 2013. | 7. Id. | 8. Id.

# NATIONAL EXAM ANALYTICS TOOL

The SEC's Quantitative Analytics Unit of the National Examination Program developed the National Exam Analytics Tool (NEAT), which is used to access and systemically analyze massive amounts of trading data from firms[9].NEAT is being used to identify signs of not only possible insider trading, but also front running, window dressing, improper allocations of investment opportunities, and other kinds of misconduct[10]. When describing the effectiveness of NEAT, Chair White stated that "in one recent exam, our exam team used NEAT to analyze in 36 hours literally 17 million transactions executed by one investment adviser"[11].

# THE FEDERAL RESERVE

Bank regulators have been more tight-lipped about the extent of their use of technology but in a recent speech, FRB Governor Daniel K. Tarullo acknowledged that technology is playing a greater role in bank oversight. Governor Tarullo stated that the Federal Reserve invested substantial resources in developing technological tools for examiners to improve the efficiency of both off-site and on-site supervisory activities. These tools should lead to greater consistency and more efficient, effective, and risk-focused examinations as they assist staff in tailoring the scope of examinations to the activities and risks at individual banks. The automation of various parts of the community bank examination process can also save examiners and bank management time, as a bank can submit requested pre-examination information electronically rather than mailing paper copies to a Federal Reserve Bank[12].

# BLUNT TOOLS FOR COMPLIANCE SURVEILLANCE

Compliance officers spend significant resources and time designing and implementing surveillance systems related to financial services regulations[13].

The scope of these systems must address a wide range of activities, such as anti-money laundering and Bank Secrecy Act/OFAC monitoring, handling of customer funds and accounts, internal and external communications, use of social media, personal trading, transactional reviews, review of conflicts of interests and more. Surveillance tools consist of off-the-shelf solutions, home-grown solutions developed by internal IT department and a hybrid of the two. In some instances, compliance officers simply use data provided by front or back office systems and develop work-arounds to conduct necessary reviews.

Compliance is heavily reliant on others, particularly IT, to ensure that it has tools and that the tools are kept current with changes to regulations, best practices or the company's business model. Compliance's reliance on other departments or service providers, coupled with budgets that may not necessarily allow for improvements to keep systems (and solutions) current, means that tools may be running on outdated platforms, not working effectively or, in a worst-case scenario, not capturing all of the needed data. According to a recent industry study, 26 percent of chief compliance officers were not confident in their IT systems' ability to fulfill all compliance and reporting requirements[14].

9. Chair Mary Jo White, 41st Annual Securities Regulation Institute, Jan. 27, 2014. | 10. Id. | 11.Id. | 12. Governor Daniel K. Tarullo, A Tiered Approach to Regulation and Supervision of Community Banks, November 7, 2014. | 13. SIFMA, The Evolving Role of Compliance, March 2013.

Budget constraints also mean that staffing the surveillance function may not keep pace with the increasing, extensive expectations of regulators[15].In a survey conducted in 2014, 40% of chief compliance officers reported that their annual budget was $1 million or less[16]. This means compliance departments are struggling with systems that may not be identifying compliance issues or mitigating compliance risks and insufficient and overworked staff trying to pick up the slack.

## EVER-CHANGING ENVIRONMENT

During the past decade, the financial services industry has undergone a sea change. The 2008 crisis resulted in expanded and new regulations while financial services industry itself has become more global and more technology-driven. As a result, the role of compliance has become more prominent, primarily due to the requirements under the Dodd Frank Act, which requires close involvement by compliance with a financial services company's day-to-day operations and decisions[17].

## CONCLUSION

In an environment of changing regulations and changing business operations, chief compliance officers are struggling with limited budgets, limited staff and insufficient technology with which to identify, monitor and mitigate compliance risks. Meanwhile, regulators are actively developing and utilizing new technology to sort through massive amounts of data and quickly identify issues. The playing field is clearly uneven.

A compliance appliance that utilizes Big Data is the answer and one that can manage Big Data intelligently – *Smart Data*, is the right answer. Existing technology has reached the point where data can be matched by relationships or other criteria without having to build complex algorithms. The result is a compliance appliance that allows compliance officers to identify and resolve compliance issues at a much more rapid pace and an environment where all the information they need is at their fingertips. Dependencies on data owners for access and upon IT to build work-arounds to develop exception reports can be eliminated. Changes to regulations or policies can be tested and entered without having to go through lengthy change management or project management processes. All it would require is a few mouse clicks by a compliance officer.

Compliance officers cannot succeed in their roles without technology that can keep pace with changes to business, regulations and the way the regulators oversee financial markets. Exception reports cobbled together with work-arounds and running on antiquated systems that are reviewed by an overworked staff is no longer the answer. It's time for a smarter solution.

14. Compliance Week, Compliance Trends Survey, 2014. | 15. SIFMA, The Evolving Role of Compliance, March 2013. | 16. Compliance Week, Compliance Trends Survey, 2014 | 17. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, H.R. 4173, 124 Stat. 1376 (July 21, 2010)

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## ABOUT NEXTANGLES

### COMPLIANCE REIMAGINED

NextAngles is an Mphasis venture developing a new breed of disruptive solutions for regulatory compliance and risk management. Our vision is to make compliance easy through a highly automated and knowledge-centric approach that provides a centralised and integrated view of data. The NextAngles solution suite can be applied across diverse risk and compliance areas, such as AML Alert Investigations, KYC, Trade-Based Money Laundering, Financial Crimes Investigation and Liquidity Risk Management, to create a smart compliance experience. This disruptive approach not just reduces compliance burden, but also increases the speed of response to business and regulatory changes significantly.
In addition, it scales to meet the most demanding enterprise-class financial regulatory requirements.


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