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INSIGHT

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Market Surveillance: Challenges Presented by the Covid-19 Pandemic

Introduction

The COVID-19 pandemic has impacted many existing compliance practices within financial services. Market Surveillance, the practice of monitoring and investigating an organization's activities for evidence of market abuse, market manipulation, and other trading regulation violations, is seeing some of the more challenging effects to the industry as both the equities markets and communication channels have drastically changed during the pandemic. Surveillance activities at US financial institutions are broadly classified into monitoring data breaches in two primary areas:

- Order & Transaction Data (pre-trade & post-trade) across various product types and markets
- Digital Communications (written & voice e-communications data)

The key monitoring and enforcement agencies in the public arena include, but are not limited to the National Futures Association (NFA), Financial Industry Regulatory Authority, Inc. (FINRA), Ontario Securities Commissions (OSC), Australian Securities Investment Commission (ASIC), and Financial Conduct Authority (FCA). These regulatory bodies enforce legislation across the breadth of financial institutions, attracting third party vendors such as NASDAQ, IBM, Thomson Reuters, Aquis Technologies, and ACA Compliance Group, whose primary objective is to develop automated and resilient market surveillance tools. Due to this vast network of interconnected agencies that are required to operate seamlessly for effective surveillance, any disruption along the process can result in serious challenges to the business-as-usual (BAU) functions. Each regulatory agency has its own enforcement guidelines and every market vendor has an idiosyncratic method of monitoring trades and communication. The pandemic has exposed several inefficiencies and the lack of operationally resilient infrastructure and the capabilities to allow for seamless BAU processes. The pandemic has created additional bottlenecks and developed a need for elevated vigilance from financial firms to ensure that they are operating within regulatory guidelines.

The 'Virtual' Environment: A New Reality

The Covid-19 pandemic has exacerbated the existing challenges in running a robust and comprehensive market surveillance program. Below are some of the key market trends Sia Partners has observed related to the new virtual and remote work environment, and the consequent impacts on surveillance programs:

- **Remote and Distributed Staff**: As economies adhere to the new normal of social distancing, approximately half of Americans are currently working from home, with the highest concentration of this subset represented by white-collar professionals. Regulators are aware of the high possibility for policy and procedure breach and market abuse through such flexible working arrangements and have consequently formed special committees to increase scrutiny on buy-side and sell-side firms. The CFTC requires firms to record telephone conversations when conducting trades in markets that do not offer transparent and fully electronic pricing. This has led to a 40% surge in new user subscriptions for cloud-based phone recording services such as Smartnumbers, which has inadvertently caused an increased number of dropped calls, platform malfunctions and technical issues, disallowing trading firms to be compliant with regulators. As an alternative, traders have been directed to manually log detailed descriptions of their conversations, which inherently increases the potential for error, manipulation and other inefficiencies[1]. Furthermore, consider a possible situation in

[1] https://www.wsj.com/articles/taking-notes-the-challenge-of-recording-trades-while-working-from-home-11585565630

which financial professionals working at competing firms and sharing an apartment in a metropolitan city, inadvertently eavesdrop on each other's private work conversations, and gaining material information on the competitor's trading strategies. Executing trades based on this non-public information would be considered a case of insider trading and lead to severe economic, reputational, and criminal repercussions for the firm and the individuals involved.

- **Adoption of Novel & Unregulated Communication Platforms:** Remote working arrangements have led to a proliferation of the use of new forms of voice and e-communication platforms for video conferencing, unauthorized Instant Messaging platforms, and other unregistered personal equipment by traders and market makers. Given the 'overnight' adoption of such communication channels, many are still not fully integrated into the surveillance networks of firms, while some platforms lack explicit usage guidelines from regulatory agencies, exposing firms to insurmountable compliance risk. Moreover, the sheer increase in volume of communications data through these platforms necessitates a more dynamic and resilient collection and processing mechanism, along with additional personnel and automated strategies to ensure that all alerts are being assessed thoroughly, and reconciled or escalated appropriately.

- **Heightened Price Volatility & Trading Volume Surge:** The coronavirus pandemic has created such market uncertainty that the S&P 500 index dropped 34% between Feb. 19 and March 23 and rebounded to close out the first quarter of 2020 at a loss of 19.6%, resulting in some of the largest single day drops in Dow Jones history. The perceived investment opportunity created by market selloffs, customer-friendly trends such as low or no cost commission fees, increased freedom, spare time and minimal supervision available through remote working arrangements have all led to a surge in trading activity and new account openings at brokerage firms. For example, TD Ameritrade claimed "retail clients opened a record 608,000 new funded accounts in Q1 2020, with more than two-thirds of those opened in March[2]." Moreover, their average daily client trades grew from one million in Q4 2019 to 2.1 million in Q1 2020[3]. With the increase in market volatility and trade volumes, the occurrence of false positives in the market surveillance process has become more prevalent. False positives, as it relates to market surveillance, are alerts produced via screening and data gathering that do not actually represent suspected illicit activity.

According to the Global Trader Surveillance Survey done in 2017 by Chartis Research, 38% of respondents claimed the high volume of false positives was their greatest market surveillance challenge.

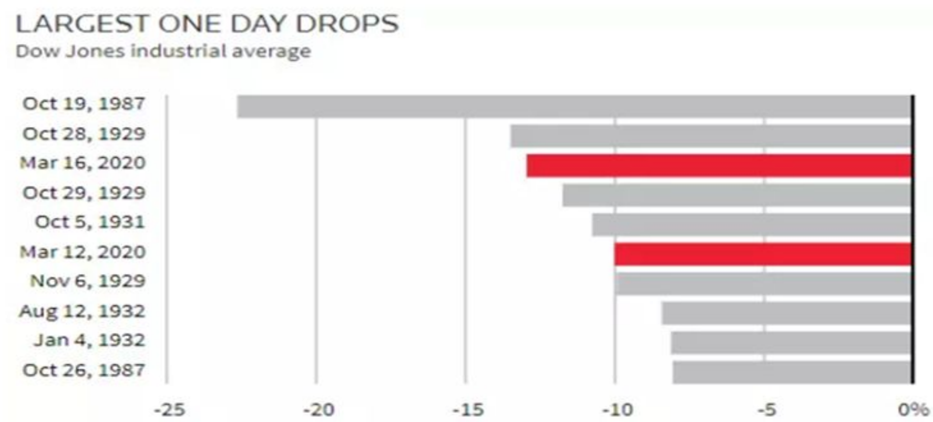
Sia Partners has experience building custom-made AI Tools and Bots to manage surveillance needs and reduce the backlog and occurrence of new false positives

The sheer volume of increased trading has compounded the production of false positives creating a significant backlog of alerts. This has caused more strain on existing surveillance programs and ensured the diversion of key resources from other strategic initiatives, all the while risking failure to correctly identify market abuse, and meet regulatory standards. For example, during the "flash crash" of 2010, which briefly wiped out nearly $1 trillion of stock market value, several trading attributes of a UK-based day trader named Navinder Sarao were flagged as potential market abuse, but many went

[2] https://www.bloomberg.com/news/articles/2020-03-30/robo-advisers-gain-new-younger-clients-amid-market-turmoil
[3] https://www.wsj.com/articles/coronavirus-turmoil-free-trades-draw-newbies-into-stock-market-11588158001

undetected by the executing brokers[4]. As processing a large backlog of false positives is expensive and inefficient, firms should ramp up their investments in machine learning and unstructured data analysis infrastructure.

- **Novel & Dynamic Trading Strategies**: Rogue traders have tried to capitalize on the opportunity to 'hide behind the noise' and attempt to profit from trading methods that tend to go undetected in



The stock market is experiencing some of its highest drops ever as a result of COVID-19. Image: Reuters Graphics

volatile environments. There has been a shift from long-term to short-term trading strategies, which inherently increases trade volumes, alerts and false positives. Moreover, there is an increased likelihood of collusion with other market participants to indulge in insider trading, spoofing, circular trading, pump and dump and spread betting schemes. Furthermore, due to market volatility and lack of surveillance technology at home, staff who have personal portfolios significantly impacted by the global pandemic might feel the need to use proprietary information, to recoup their steep losses. This increase in the likelihood of abusive trading practices coupled with a general increase in trading volumes due to volatility warrants, more than ever, the adoption of impenetrable, adaptable and tenacious market surveillance systems.

Potential Regulatory Focus

Trade and Order Data Surveillance:

Regulators will have a heightened focus on market surveillance during the global pandemic, as an increase in trade volume also means an increase in communication across unsecured platforms such as cellphones, landlines, and video conference services. To allow financial institutions to focus on improving their market surveillance policies, regulators such as the CFTC, ESMA (European Securities and Markets Authority), and BaFIN (Federal Financial Supervisory Authority) have become more lenient with filing deadlines and issued a series of temporary, targeted relief to designated markets.

With regulators giving temporary targeted relief on filing deadlines, investment banks and other financial

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[4] https://www.reuters.com/article/health-coronavirus-nasdaq-surveillance/nasdaq-warns-of-market-manipulation-during-coronavirus-volatility-idUSL1N2BD14L

services organizations can address the following challenges below:

- New tactical regulations will be released, intra-day, and require immediate implementation, e.g. with market/exchange-specific short selling bans or reporting requirements on magnitude of moves
- Investors will have near-constant requests about risk exposures and returns, all which require disclosure and content reviews [5]

The increase in trading volume might be difficult to monitor with working remotely and potential hiring and onboarding freezes due to the pandemic, but the increased volumes also opens the possibility of regulators catching severe errors during a market conduct examination.

Communication Surveillance:

Although postponing regulatory deadlines will help financial institutions focus more on regulating their trades during this market volatility, challenges still arise on how to monitor employees when a majority are using their personal cellphones and video conferencing platforms such as Zoom, Cisco Webex, Google Meet, and Microsoft teams to complete their day to day work. Due to the data privacy and General Data Protection Regulation (GDPR) restrictions, banks will most likely not be able to monitor employees cell phones and land line conversations, and video conferencing platforms such as Zoom, Google Meet, Microsoft Teams, and Cisco Webex also bring challenges when it comes to monitoring activity. According to an analysis from the analytics firm SimilarWeb, in the last month there was a 535% rise in daily traffic to the Zoom.us download page.[6] Non-regulated video conferencing platforms can hold up to 250 to 500 people per call and each have the capability to record meetings but vary on if the recordings are automatic or need to be manually requested. Along with the challenge in monitoring employee' activities on these platforms, another issue arising is confidential information being stolen or video hijackings. Additionally, Zoom has come under scrutiny for how they install their program within a user's computer. Zoom's installer has been known to take over admin privileges to gain root access to a user's computer, meaning programs can be installed without a user's knowledge, including the ability to access a user's webcam and microphone.[7]

Next Steps

Due to the increase in possible market manipulation, the volume of trades occurring, and unmonitored communication across various unregulated platforms, entities, especially financial institutions, should consider, evaluate, and implement innovative approaches to meet growing market surveillance needs with a focus on the following areas:.

- Enhance market surveillance policies and procedures to include direction regarding communication platforms such as Zoom, Google Meet, and other non-regulated platforms.
- Entities should tighten their work from home policies and procedures to ensure that their employees dealing with sensitive information are working in a secure location.
- Adjust market surveillance technology filters to account for the dramatic increase in trade volume. It is crucial for institutions to ensure they are flagging and reporting the most high-risk transactions, and not forming too great of a backlog of false positives.
- Sia Partners' industry experience has shown that implementing AI and Data Science solutions can drastically decrease the number of false positives and generate immediate ROI through operating expense reduction.

[5] https://www.acacompliancegroup.com/blog/mitigating-employee-risks-related-covid-19-pandemic

[6] https://www.theguardian.com/technology/2020/apr/02/zoom-technology-security-coronavirus-video-conferencing
[7] https://nymag.com/intelligencer/2020/04/the-zoom-app-has-a-lot-of-security-problems.html

- Manage the workload of surveillance teams so that false positive alerts do not form a backlog.
- Offer employee trainings on the newly enhanced policies and procedures.

Market Surveillance & Sia Partners

With these new challenges to market surveillance brought on by remote working and virtual communication, Sia Partners is ready to assist our clients with their market surveillance needs with innovative and comprehensive solutions. Our market surveillance capabilities include:

Design Target Operating Model

Project management of any market surveillance team transformations or changes

Gap analysis of your current program

Determining or implementing a strategic path to achieve future state requirements

Automation & Data Science

Automation and process optimization of the market surveillance process through data science

Building custom made AI Tools and Bots to manage surveillance needs and reduce the number of false positives

Third Party Vendor Evaluation

Assessment of third-party market surveillance tools and equipment

Evaluating and managing vender risk and compliance framework

Ability to tailor vendor systems based on future needs, requirements, and regulations

Program Implementation & Assessment

Platform adoption & change management

Responding to regulatory or internal audit requests

Performing surveillance monitoring and screening

Remediating the backlog of false positives

Policies, Procedures and, Training

Drafting, editing, and enhancing market surveillance policies and procedures

Training employees on best practices

Update and maintain training procedures and documentation

Key Takeaways

- Trade volume has increased dramatically due to the heightened market volatility as a result of this global pandemic

- Trade strategies shifting from long-term to short term, which causes concern for a higher risk of market manipulation
- Institutions' policies and procedure may not be updated to reflect the increase of employees utilizing personal cellphones or landlines while working remotely
- Video conferencing platforms have seen an increase in usage, but are susceptible to possible hacks and questionable installation methods
- New communication platforms are not in scope of surveillance yet and could be subject to regulatory scrutiny or focus
- Updating an institutions' technology tools with the latest AI can help reduce false positives associated with the increased trade volume
- Enhancing an institutions' policies and procedures can assist with lessening the risk of employee use of unapproved alternative communication platforms while working remotely

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