Brokerage Firms Take Action to Detect Potential Rogue Traders in Their Midst

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Rogue control.

That's the name of the game at many money-management firms and brokerage houses these days, in the wake of a spate of "rogue trader" incidents during the past two years.

At **Fidelity Investments**, the nation's largest mutual-fund complex, traders who violate any of several guidelines may see red flames burst into view on their computer screens. Denis M. McCarthy, president of Fidelity Management Trust Co., says the alarm may be set off, for example, if a trader exceeds the limit of 10% that a mutual fund may own of a company's stock, or tries to buy a foreign stock for an account that is supposed to hold only U.S. stocks. As the trader gets "flamed," a bulletin is automatically zipped to the firm's compliance department.

That is one example of how financial firms are trying to harness technology to rein in potential rogue traders. But technology alone won't do the trick, so firms are also trying to tighten procedures in other ways. One money-management firm, for example, has notified each of its major brokerage houses that they should refuse to process futures orders from its traders if they exceed a specified size.

Four major incidents have made brokerage houses and money managers eager to tighten up their controls:

- At Kidder Peabody last year, trader Joseph Jett was accused of faking $350 million in government-bond trading profits, masking losses of $85 million over a two-and-a-half-year period. Kidder subsequently lost its independence and was absorbed by **PaineWebber Group** Inc.

Mr. Jett has denied any wrongdoing, saying his trading was authorized, and his profits were real. The Securities and Ex-

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Alleged Rogue Traders

Kidder Peabody said he masked $85 million in bond-trading losses by faking $350 million in gains.

Joseph Jett

His big bets on Japan's stock market were blamed for the downfall of 233-year-old Barings PLC.

Nicholas Leeson

The Daiwa Bank trader is accused of concealing more than $1 billion in bond-trading losses over 11 years.

Toshihide Iguchi

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change Commission has informed him that it plans to recommend civil administrative charges against him, Kidder, and two other individuals. The SEC and the U.S. attorney's office in Manhattan continue to investigate the case.

• At Barings PLC, trader Nicholas Leeson allegedly bet heavily and wrongly that the Japanese stock market would rise, then concealed his losses while trying to trade his way out of them. The damage was huge: about $950 million and the destruction early this year of a firm that had endured for 233 years. Mr. Leeson is awaiting trial in Singapore.

• At a subcontractor to the Common Fund, trader Kent Ahrens was accused of violating trading guidelines and making an unauthorized bet that the stock market would fall. The incident, which came to light this summer, nicked the colleges that invest through Common Fund for $138 million in reduced profits. Mr. Ahrens hasn't made any public statement of guilt or innocence. He is the defendant in a civil suit brought by Common Fund, and is being investigated by federal and state securities agencies.

• At Daiwa Bank, trader Toshihide Iguchi allegedly accumulated $1.1 billion in losses trading U.S. government bonds over an 11-year period, and concealed the losses by selling other securities and forging documents. When officials of the Japanese bank learned of the problem in July, they engaged in an alleged cover-up of their own, not telling U.S. banking authorities about it for two months. Daiwa Bank was expelled from the U.S. on Nov. 3. Mr. Iguchi has pleaded guilty to federal charges of criminal fraud. He is cooperating with a government investigation and awaits sentencing.

Blame It on Derivatives

The problem of rogue traders isn't new, says Jan Twardowski, President of Frank Russell Securities Inc. in Tacoma, Wash. "What's new is the types of securities. The biggest category is derivatives. These things get so complicated that senior people in firms don't necessarily understand them, nor the surveillance required."

Trades are larger and, as a result, losses pile up more quickly. "Hundreds of millions of dollars on a phone call are normal now," says Mr. Twardowski. "So it's easier to lose control."

Since big trades and exotic securities raise a firm's risk profile, some firms are cutting the size of positions, and reducing or eliminating the use of derivatives. Derivatives are securities whose returns are derived, often in a magnified way, from the price change in another asset such as a stock, bond, or commodity.

"Many of my clients" are trimming derivative positions, says Lisette Keto, president of Athena Capital Advisors, a San Francisco investment consultant that specializes in risk management. But she compares firms that avoid derivatives altogether with "those who act like an ostrich and bury their head in the sand."

"The incremental returns from investing in the esoteric products can be quite high," Ms. Keto says. She favors their continued use, but with "more education and better controls."

A Cardinal Principle

A common factor in most rogue-trader debacles was that the same person had responsibility for trading and for at least some bookkeeping functions. If there is one cardinal principle everyone agrees on, it is that the two functions must be kept separate.

A firm's operations department, which handles bookkeeping, is supposed to play a critical checking role. But operations people are sometimes negligent or swamped by the sheer volume of trades they are supposed to monitor.

"In Barings, the trader was too close to operations," says David Dreman of Dreman Value Management in Jersey City, N.J. "Barings had accounting systems that were probably pre-Napoleonic. At Kidder Peabody, I suspect that with these billions of confirmations, operations let it go right by them."

One big money-management firm that declines to be named has just appointed a risk manager to "oversee the entire trading floor to make sure that nothing looks suspicious," according to the firm's attorney. Any unusually large stock trade automatically pops up on the risk manager's computer screen.

The same firm has tailored its compensation system to discourage any potential rogue trader from making an oversized bet. According to the attorney, many traders operate in an environment where "if you gamble and you win, you get a big bonus. If you gamble and you lose, you just change firms." To avoid that scenario, he says, "we don't compensate people on how their account does."

Investment returns that differ greatly from what would be expected — even returns that are pleasantly higher than normal — should be a red flag, says Tom Monroe, director of Equity Research at Frank Russell Co. That flag should have waved for officials in Orange County, Calif., and for investors who bought bond funds from Piper Jaffray Inc., the Minnesota brokerage house, Mr. Monroe says.

The county, and investors in the Piper bond funds, received high returns on fixed-income portfolios for a time. But the underlying investments were riskier and more complex than many of the investors realized. They subsequently blew up, producing losses.

Bear Stearns & Co. has long used a strikingly direct method to head off rogue traders. It pays employees bonuses to inform on colleagues who mismark positions or violate trading limits, among other things. "It works," says Alan "Ace" Greenberg, Bear Stearns's chairman.

Despite all the precautions, almost no one claims there are foolproof systems of rogue control. "A dedicated thief can win in any line of business," laments Mr. Twardowski.

Michael Siconolfi contributed to this article.

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