

Algo Trading Controls and Governance

Working Group Q2: Thursday, 26th May 2022

The Commercial Case for Controls

"If we're going to drive fast and take chances in order serve our clients and drive profitability, we need to have the right guardrails, airbags, seatbelts, ability to see around the bend and stop on a dime. As our business becomes more sophisticated at taking risk, 1st line controls teams need to be as sophisticated, and I would argue, even more sophisticated to manage risk. Human + machine can help."

Shelly Liposky, Managing Director, Head of Business Risk and Solutions, BMO Capital Markets.



Outline:

20 member banks of the International COO Community (iCOOC) participated in the May Q2 2022 Algo Trading 1st Line Business Controls Working Group. In attendance was the global leads for 1st Line Risk, Controls and Governance for Algo Trading.

Objective:

- To establish a strong commercial case for controls beyond the boundary demand.
- To discuss the future operating state of the three lines of defence (3LoD) model, to explore the dynamics between first and second line in the 3LoD model and address staffing challenges between 1LoD and 2LoD

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Meeting Minutes Pages 4 - 7

Appendix:

Appendix - Survey - live results
from the audience's views on the 3LoD Pages 8 - 13



Attendees:



Areas of Resistance to Controls:

- It is hard to get buy in on the utility of controls from many business heads.
- Roles and responsibilities allocation between the lines of defence can make dealing with the other lines of defence challenging.

Overcoming Resistance to Controls:

- A culture of healthy dialogue between the three lines of defence is important.
- Reposition 3LoD as assistance for the business, to support and not frustrate business effort.
- A reliable controls function builds confidence not just in the business to operate but in a bank's clients.
- More sophisticated risk taking necessitates more sophisticated risk management.
- A reduction in conduct, operational and risk failures will manifest itself in a reduction in regulatory scrutiny, remediation, and fines, retaining capital in the business for reinvestment and reward.
- Firms must be nimble in getting people in the right place, who must stay out of the way until they are needed.
- Risk assessments that contain duplication must be improved.
- Resistance lessens as the maturity of the 3LoD model in the firm grows.
- Partnerships between the business, compliance and audit to look at issues as they develop and put in place action plans.
- Driving change that is appropriate from a business perspective, with compliance and audit, allows push back when necessary.
- Stronger collaboration between the three lines of defence and an effective challenge process that allows greater visibility.
- Moving away from those of lengthy Word documents and Excel spreadsheets into a more automated environment.
- The introduction of support tooling across the control framework, particularly Governance, Risk and Control (GRC) tools, can give firms the ability for continuous assessment.
- Avoid putting a lot of controls in place that can be considered overly bureaucratic, complex, convoluted and frustrating to work with, not only for the heads of the business, but from the control parties as well.
- Where value can be seen in the mitigation of risk, there is no challenge from the business, and it will invest time, money and resources to put controls in place.
- Internally rebranding or reframing the control office into this non-financial risk function.
- Positive feedback from regulators on first line controls, helped conversations with second and third lines of defence.

Areas to Watch:

- Assessments that either are set at too high a level or are too granular, particularly for very bespoke intricate controls like those required for electronic trading, can result in an ineffective risk management assessment.
- If a second line function attempts to document controls built by the team that developed the functionality, or if a control organisation is brought in which does not know the specificity or does not have that SME experience, the control inventory will be weak and unusable.
- Resistance may be not to controls in general, but to a particular control. For instance, in the model risk space which requires a large volume of documentation.

Task Allocation Dynamics and Staffing

In 2021, Armstrong Wolfe presented to the FCA a paper, 2021 Report: A View from The First Line, which aggregated the chief control officer community's views of the three lines of defence model (3LoD). Twenty-seven banks joined the presentation to the FCA, where a series of principles was put forward that, if adopted, would help to eliminate some of the inefficiencies in the 3LoD model.

Impressions of Regulators' Stance on 3LoD model:

- At that meeting, the FCA emphasised that it does not have a pre-ordained view on the rigidity of the 3LoD model.
- The FCA has stated very publicly it wants it to be clear where tasks are done, and it wants the model to work well.
- If the FCA does not deem something to be working well enough, the view is to default to a stricter interpretation of the 3LoD model; However, this can mean that it is more challenging for banks to make any changes that appear unconventional.
- The Canadian regulator made strong recommendations on how tasks are performed, with more emphasis on first line ownership and less on the second line ownership.
- North American regulators are starting to exert their influence and their views of what is appropriate and how the 3LoD model should operate.
- Any new stance by regulators is felt earlier in the UK and US before it is felt in Canada.
- The Office of the Comptroller of the Currency (OCC) recently pronounced that the 3LoD model includes flexibility in terms of its view of the tasks in each line of defence.
- Rigidity in the approach to the 3LoD model was initially introduced by firms at the model's inception. Regulators affirmed this interpretation, incorporating it into their stance.

Changing the 3LoD Model Interpretation:

- There are some organisations where the interpretation of the model is so embedded that any shift is challenging.
- There appears to be an initiative to bring in external resources, redevelop audit assessments, bringing people from the first line with risk management experience in to the third line.
- Shifts in control ownership, such as surveillance, wherein accountability and responsibility is moved to the first line has yet to be untangled.
- Making any radical change is best approached in small steps and with small changes. The regulator will require an explanation at each step and to approve before the change is made.
- Banks that are not so advanced in implementing a 3LoD model may have an advantage as they can leapfrog the work done by earlier banks to develop the model.

Staffing the 3LoD:

- There are acute recruitment issues for roles in the first and second lines.
- Moving responsibility and accountability for surveillance into the first line from the second line creates a challenge.
- Aligning IT and risk management frameworks is an ongoing problem for many organisations, which manifests in the trading and arbitrating oversight forums.



Overcoming Technical-skill Shortage in Second Line

The Making of Specialists:

- Algo self-assessment requires developing generalists into specialists, but this makes those people more marketable, and staff can be lost to other firms.
- A degree of flexibility in the structure of the model is needed as specialists can have their own preferences in whether they work in the first or second line.

Addressing the Skills Gap:

- A closer alignment of the first and second lines of defence, allowing staff to move between functions, and the movement of staff within organisations, are attempts at bridging that knowledge and skills gap.
- The maturity of the risk being managed is what matters. In new business areas, there is a lack of a second line with appropriate expertise. So, this risk must be managed in the first line, where the risk is being taken, at first, while the second line is developed.
- The shortage of resources in the second line means banks must manage the flow of talent. Potentially, staff with some of the required knowledge and skills in the middle office, operations and audit can be moved into the second line.

Technology to Enhance 3LoD Model:

- The use of technology is the optimal approach but skills across teams must be constantly updated.
- Giving people in operational risk management the responsibility of reviewing controls and evidence for algo trading, requires education and the right tools.

Training for 3LOD Staff:

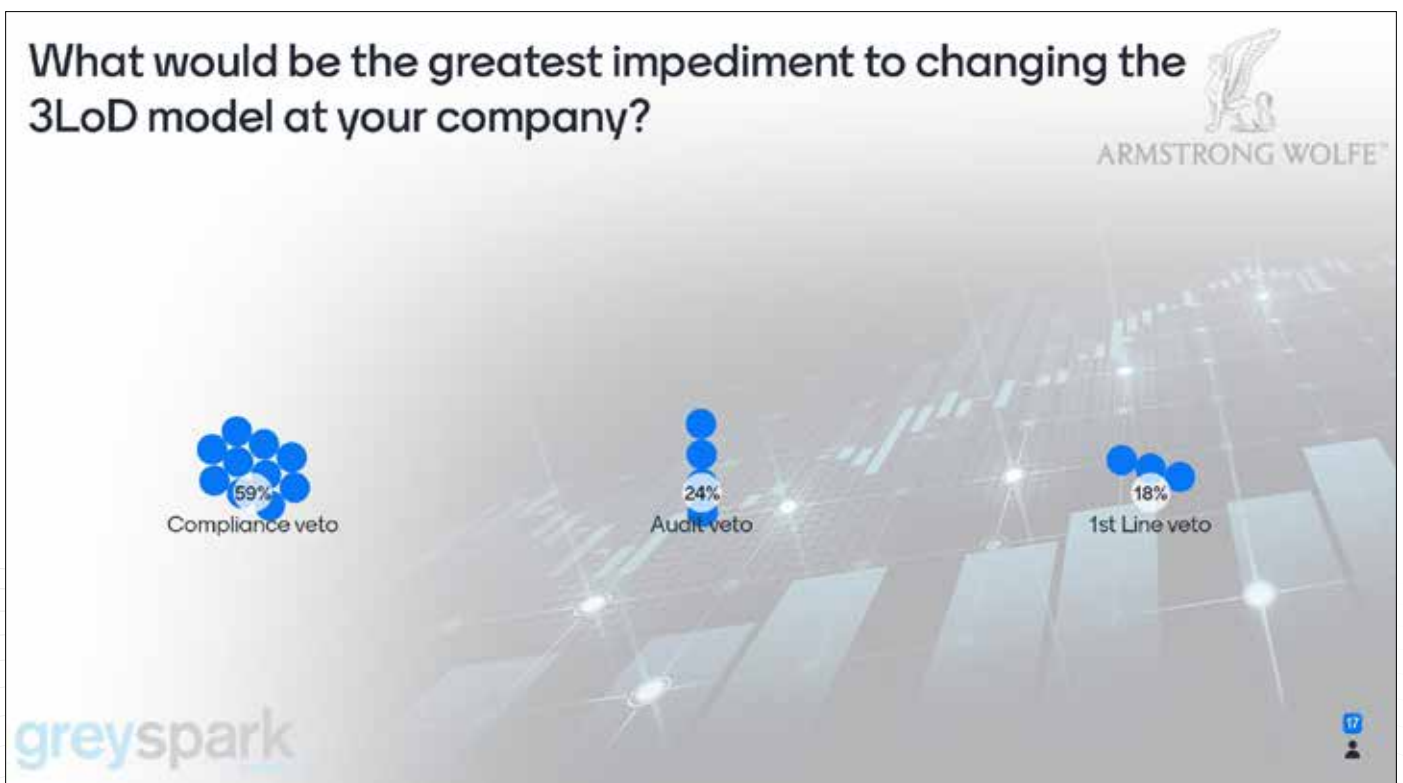
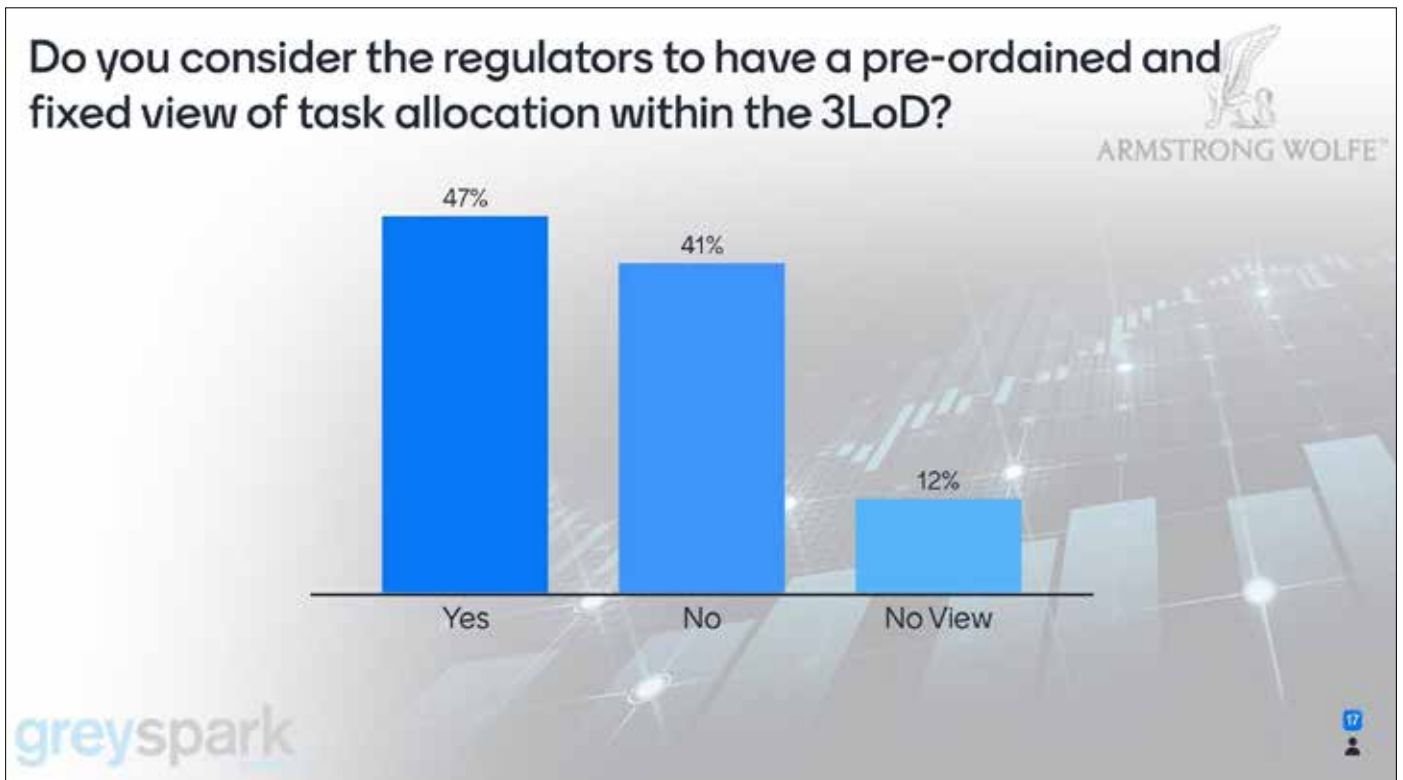
- Training to educate the second line in particular technical perspective as well as in more generic control awareness is typically developed in-house by the business.
- To properly assess algorithmic trading activity, people with a lot of knowledge to understand the markets, the systems, and the algorithms, as well as the regulation, are required.

Multi-function Approach to Assessment:

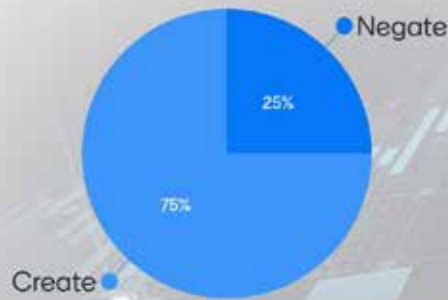
- RTS 6 Self-assessment is done by the first line, with gaps being identified by the business.
- The operational risk team typically produce the RTS 6 validation report.
- Some operational risk staff lack the necessary technical knowledge, but this can be overcome by consulting market risk, credit risk, audit, and risk and technology partners, and utilising committee structures.
- Comprehensive oversight required for RTS 6 can be achieved by revisiting every single article and sub article in the regulation.

End.

Appendix Live survey results: Views on 3LoD



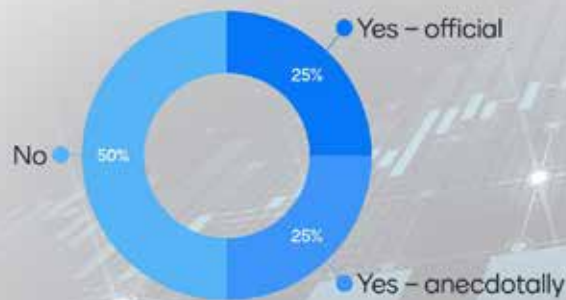
Does lack of clarity by regulators on the 3LoD model negate the opportunity to initiate change or create an opportunity to develop fresh perspectives?



greyspark



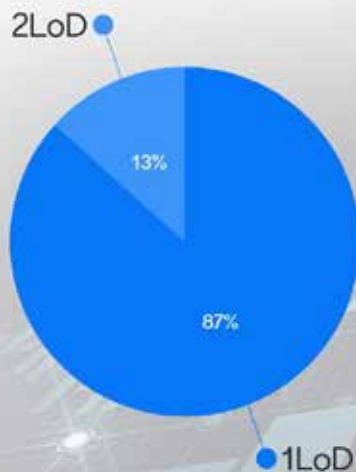
Do you officially or anecdotally use the term 1.5 or 1b LoD in your company to define the positioning of 1st line controls activity?



greyspark



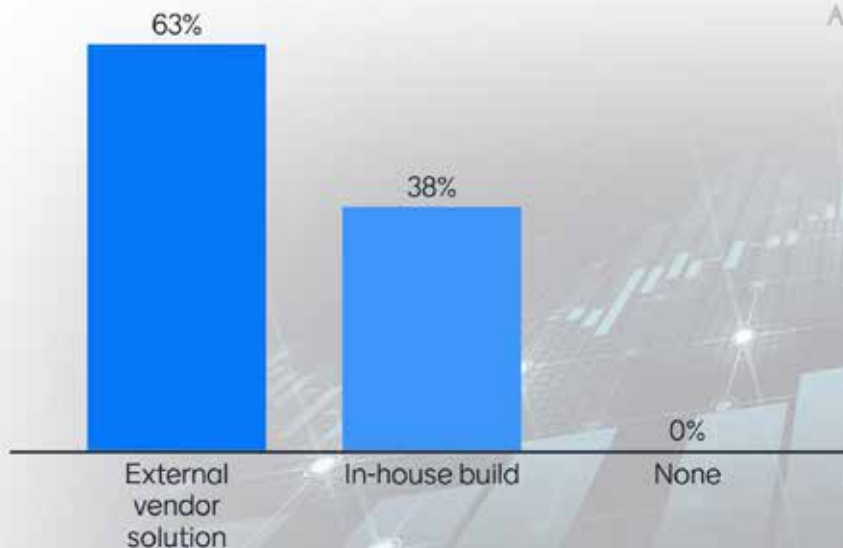
Is surveillance better served in 1 or 2LoD?



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What surveillance technologies do you use?



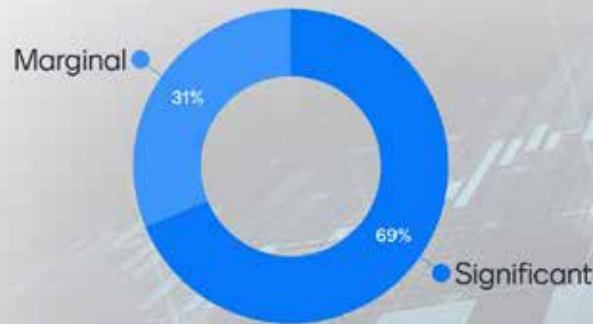
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How do you assess the knowledge and skill divide between 1LoD vs 2LoD?



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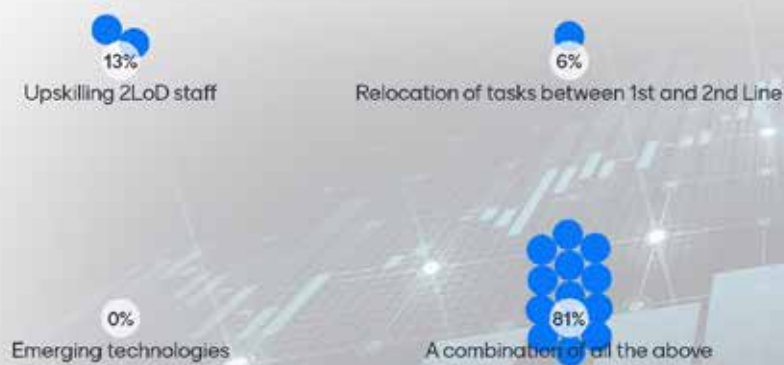
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What is the best approach to addressing the technical skillset shortage in 2LoD?



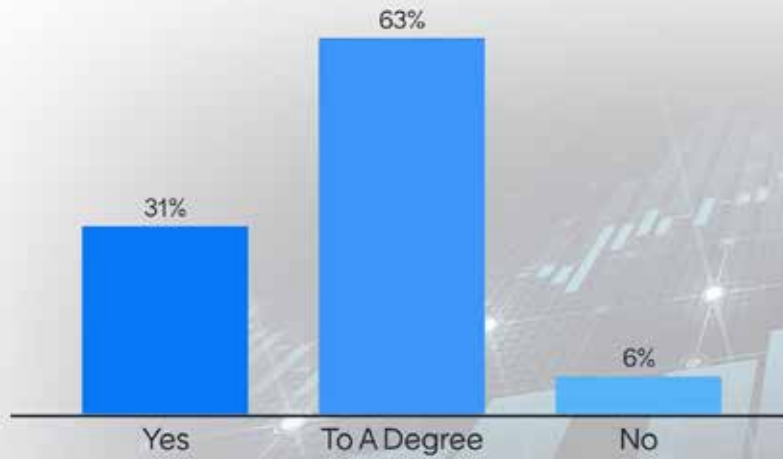
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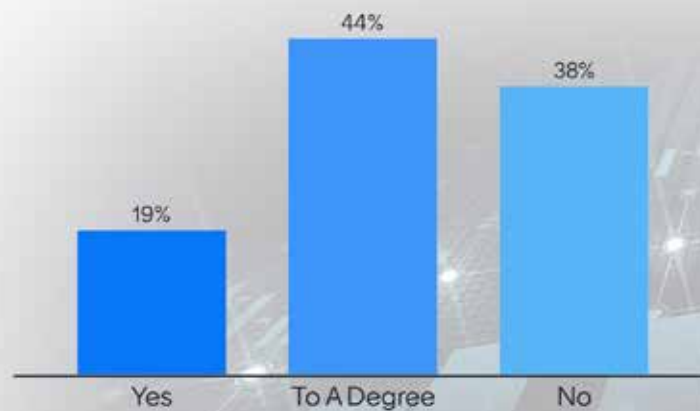
Do you believe the business understands the value proposition of the 1st line controls function?



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Do you consider the business perceives controls as a necessary evil as opposed to a commercial asset to the business?



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What is the main reason the business pushes back on control activity?



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Cost



Frustrates the business effort



Lack of understanding of the value of controls

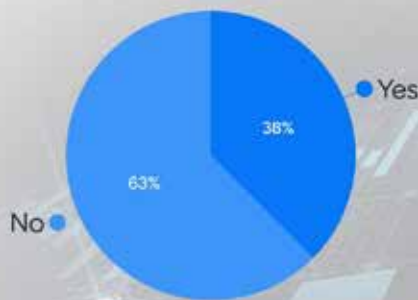
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Do you have a consistent approach to measuring the value of controls work that is above the mandated by regulation?



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No

Yes

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