Why Trades Fail, the Consequences of Failed Trades, and the Key Role of Reconciliation

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By Todd Sloan
Failed trades occur when the seller or the buyer does not meet their trading obligations on or before settlement date. Whenever this happens, the party who failed to deliver cash or securities on their side of the trade could face financial losses, fines and damage to their reputation on the street. Failing to meet their trading obligations may result in rating agencies downgrading their credit score, limiting their ability to shop around for the best counterparty relationships, and paying higher penalties under new T+2 settlement regimes.

While automation can play an important role, many investment operations managers are still dealing with errors and delays that lead to higher operational costs and risks. What is the solution? First, let's take a look at the reasons why trades fail and their effects on the health of an investment management firm.

**Why Trades Fail**

So, why do trades fail? There are three key reasons why trades fail: (1) issues with funding and inventory of investment assets; (2) inefficient manual processes; and (3) failures of automated systems to produce accurate data and integrate with the reconciliation process.

With funding and inventory issues, the buyer:

- May not have enough cash in the account designated for settling trades with the custodian
- May not have credit line in place or an overdraft agreement with the custodian in the event of a cash or credit deficiency in the account being traded
- Does not have a netting agreement in place with the counterparty

Or, the seller may not have possession of the security to deliver. This often occurs when the investment manager's underlying client is engaged in securities lending programs where the security is not in their possession at the time of settlement.

Manual trading processes lead to errors and delays in confirming, affirming or matching trades before
settlement date. This can cause the failure of settlement instructions being delivered at all to custodians by brokers, or inaccurate or stale settlement instructions create discrepancies between buyer and seller.

Sometimes, inaccurate information related to the reason of a failed trade is the culprit, and can cause staff to spend precious time on erroneous exceptions – which can have a domino effect across the entire post-trade process. In addition, even an automated trade fail system can produce low quality data and operate completely disconnected from the reconciliation process, leading to process silos and inefficiencies across the entire post-trade process.

**The Serious Impacts of Failed Trades**

When a trade fails, the effects can range from operational costs and risks, as well as damage to reputation and relationships with counterparties.

The party who fails to pay or deliver the security may be asked for compensation for the opportunity costs on the value of the deal until settlement is reached. Or, the party who failed to pay or deliver the security may be asked to pay fines for failing to meet their trading obligations. Although the European Settlements and Markets Authority (ESMA) has postponed the Central Securities and Depositories Regulation’s (CDSR) Settlement Discipline Regime (SDR), daily penalties for each transaction that fails to settle in T+2 could threaten front-office commissions as well.

There are also hidden costs that many investment operations managers often ignore, including those originating from tasks such as reconciliation, investigation of failed trades, and negotiating compensation terms with their counterparties.

**The Crucial Role of Reconciliation**

The first step an asset manager can take to solve these issues and reduce the occurrence of failed trades is to automate the trade entry process. Although one would think just to simply automate would be enough to meet the challenge, trade entry, trade fail and other post-trade systems fall short on data quality and integration with other processes such as reconciliation.

This begs the question, “Why not look to a reconciliation solution to solve the problem?” Such a solution should help firms to ensure high data quality and prevent failed trades while providing a solid framework for managing them. This would include:

- Delivering a fully reconciled view of security positions, uninvested cash, and short-term investment funds (STIFs) or money market balances available for trading
- Supporting the daily collection and reconciliation of non-traditional data such as standard security instructions (SSIs)
- Identifying potential fails long before they occur by pointing to negative or below threshold cash balances, as well as those related to shares on loan and collateral held
- Maintaining intraday matching of trade details on trade date to identify mismatches on user-defined data elements

When fails do occur, the reconciliation solution should be able to:

- Gather and normalize failed trade data across hundreds of custodian and brokers relationships
- Provide a global view of failed trades and related exposure
Offer robust exception management capabilities for identifying and monitoring the investigation and resolution of potential and failed trades.

A change in perspective about the key role of reconciliation is needed throughout the investment management industry to solve the challenges of failed trades and meet future SDR requirements for settlement efficiency. About 30 percent of the top 200 global investment managers are already using their reconciliation solution to prevent and efficiently manage failed trades, as well as improve their entire post-trade process. What's stopping your firm from doing the same?

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Todd Sloan is a results-driven executive who has spent more than 20 years helping the investment management community connect with automation in the areas of reconciliation and exception management workflow. He drives Electra's buy-side industry engagement and solution strategies.

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