

Financial Institution Risk Management

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Smoke or Fire? Warning Signs of Risk, Operations, and Trading Concerns

In fast-moving markets, small issues rarely stay small for long. If prevention is the best medicine, early detection is a close second – and in some cases it is the only meaningful defense. Trading activity can escalate, positions can balloon, and patterns can emerge in a matter of hours, not weeks. History is full of examples where fortunes were made or lost in moments, and where those same moments later became the focus of investors, senior management, and regulators.

The challenge for financial institutions is not simply responding when something goes wrong, but recognizing when “smoke” may be signaling a much larger fire. Below, we explore several common early warning scenarios, why they matter, and how firms can position themselves to identify and address them before they evolve into business, legal, or regulatory crises.

Promises Made, Promises Scrutinized

Many of the most consequential disputes – commercial, regulatory, or criminal – trace back to the very beginning of a client relationship or investment decision. The representations, disclosures, and expectations established at inception often become the “true north” against which conduct is later measured.

What was said about risk tolerance?

What assumptions did clients or investors reasonably rely upon?

What representations were made about strategy, liquidity, or controls?

When market conditions shift or business strategies evolve, divergence from those baseline expectations can occur quickly and sometimes unintentionally. But in hindsight, those deviations are often framed as broken promises rather than adaptive decision-making.

Key takeaway: Legal, compliance, and risk professionals should be involved early and often – both during initial discussions and when circumstances begin to change. Being read-in at the first sign of

deviation gives institutions a fighting chance to correct course, manage disclosures, and significantly reduce downstream exposure.

Patterns Tell Stories, Especially When They Change

There is a reason regulators, internal audit teams, and plaintiffs' lawyers all focus on patterns. Once a baseline is established, deviations can become difficult to explain away.

Unusual trading behavior.

Outsized or inconsistent risk-taking.

Recurring operational "one-offs" that no longer look isolated.

The challenge is that many firms are operating in an environment where the pace of innovation—and the race to deploy sophisticated surveillance and analytics—outstrips governance and oversight. Technology alone does not solve this problem. Systems can flag anomalies, but people and processes determine whether those flags are meaningfully investigated or quietly ignored.

Key takeaway: Institutions should ensure they have not only the tools to detect aberrant behavior, but also clear escalation pathways and accountability when patterns break from the norm. Early, well-documented inquiries often make the difference between an internal course correction and an external enforcement action.

"That Escalated Quickly": When Risk Compounds

Competitive pressure rewards growth, speed, and confidence. But some of the most dangerous risk dynamics emerge when success compounds unchecked.

A profitable strategy becomes a larger position.

A larger position becomes leverage.

Leverage becomes concentration.

What begins as a rational effort to maximize returns can quickly morph into a market-moving—or market-cornering—position. At that point, risk is no longer confined to a desk or portfolio; it can threaten the firm, its counterparties, and its investors.

Too often, the warning signs are visible well before the outcome is inevitable. Limits are approached. Exceptions become routine. Concerns are raised but overridden in the name of performance or opportunity.

Key takeaway: Firms must empower legal, compliance, risk, and operations teams not just to identify escalating risk, but to meaningfully challenge it. Authority without influence is not enough. When these functions lack the institutional heft to slow or stop activity that poses unreasonable risk, the consequences tend to surface later—publicly and expensively.

The Human Factor: Culture and Escalation

Early warning signs are rarely hidden but they are often rationalized. People convince themselves that a deviation is temporary, that a control can be revisited later, or that speaking up will be unwelcome.

Culture plays a decisive role here. In environments where escalation is viewed as obstruction rather than protection, smoke is more likely to be ignored. In contrast, firms that treat early escalation as a strength—not a failure—are better positioned to navigate volatility without attracting unwanted attention.

Key takeaway: Institutions should regularly test not just their controls, but their escalation culture. Are issues surfaced early? Are concerns documented and addressed? Or do they resurface only after losses, client complaints, or regulatory inquiries force the issue?

Conclusion: Acting While There's Still Time

The difference between smoke and fire is often time, and whether an institution is willing to act before certainty sets in. Early warning signs in risk, operations, and trading are not admissions of failure; they are opportunities to intervene while options still exist.

Firms that invest in early detection, empower their control functions, and revisit foundational promises as conditions change are far better positioned to weather market stress—and to explain their decisions when hindsight scrutiny inevitably follows.

In today's environment, the question is rarely whether warning signs existed. It is whether they were recognized, escalated, and addressed while there was still time to do so.

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If you have any questions concerning any of these matters, please contact your primary Seward & Kissel attorney or a member of the [Financial Institution Risk Management](#) practice at Seward & Kissel.