Financial Conduct Authority

FCA
FINANCIAL CONDUCT AUTHORITY

Market Watch

Newsletter on market conduct and transaction reporting Issues

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You can also find issues on our website at: www.fca.org.uk/firms/markets/market-abuse

Further observations from suspicious transaction reporting (STR) supervisory visits

In Market Watch 48, we gave some observations from our STR supervisory visits in 2013 and 2014. In 2015, we continued our visit programme and undertook 38 supervisory visits to firms to better understand and assess the way in which potential incidents of market abuse are being identified. This remains an important area of work for us and we continue to work with firms to help them deliver high-quality STRs to the FCA, based on effective and well-developed surveillance programmes. In this article, we present some further observations from our visit programme and encourage firms to consider these, together with those we made in Market Watch 48. The issues raised will continue to be a focus for us in visits over the coming year.

In line with our commitment to transparency, please also note that 2015's STR statistical submission data has recently been released and can be found on the STR pages of the FCA website.

Offshore surveillance teams

We are increasingly seeing firms move parts of their surveillance teams offshore or 'near shore' to centres in other parts of the UK, EU or other countries. These offshored centres carry out an important function: in many cases they perform the first filter on generated alerts before the behaviour is passed on for further review. These centres therefore have a significant impact on the quality of surveillance that firms undertake and it was for this reason that we decided to visit a number of them in 2015; we wanted to see, first hand, the work that was being carried out.

We observed some examples of effective offshoring of parts of the surveillance process. Some firms have strong training and development programmes for offshored staff, assisting their integration into the onshore surveillance team and ensuring that, where necessary, they are able to effectively challenge the business and escalate issues of concern. We also saw examples of significant quality assurance being undertaken. It appeared that quality assurance is a key control in ensuring that offshore staff analyse alerts consistently and in line with the standards set by the onshore compliance function.

In addition, we noted that some firms have an ongoing programme of visits from their central compliance function to the offshored centres, which may contribute to the effective integration of the team into surveillance processes. In some cases, this was as often as monthly and was used as part of the training and development of these staff.

We noted that some firms have service-level agreements in place with their offshored surveillance functions to ensure that work is carried out to a sufficient standard and within an appropriate timeframe. Analysis of the investigative work undertaken within this part of the surveillance process was a material part of our work on these offshored centres, and we noted the importance of giving the offshore team full access to the necessary systems (such as the firm's central data repositories, communications data stores, and market information sources). In addition, we saw good results where analysts performed an investigation on the alerts that went beyond an initial, elementary review. We have seen examples of firms being very prescriptive with analysts and not encouraging them to look beyond the initial alert: for example, a 'wash trade' alert might not ultimately give rise to suspicion of wash trading, but might instead indicate a different potential market abuse, such as potential layering.

Independence of market abuse surveillance functions
Firms are increasingly posing questions to us on visits in relation to how market abuse surveillance functions should fit within the first (front office) and second (compliance) line of defence structure. We have seen many successful examples of firms organising surveillance team structures within the broader compliance model, and we are aware of instances where some transfer of responsibilities may currently be occurring between second line and first line.

Traditionally, we have seen firms positioning their surveillance functions within the second line of defence. Some firms then provide very detailed management information to the first line of defence management in order to stimulate debate and challenge. We have seen many effective examples of this, especially where the first line can add colour, context and further background detail (such as why certain clients or traders may be alerting more than others). Our experience has demonstrated, however, the importance of having a well-resourced and independent second-line surveillance function in order to provide genuine challenge to the business.

Where we have seen certain functions of surveillance being moved from the second line to the first line of defence, we have seen examples of firms inadequately considering the potential conflicts of interest in the positioning of this surveillance. Our experience has shown that the most effective surveillance generally comes from an independent function with a reporting line to senior management that is, as far as possible, non-conflicted. While it is important for the first line to be engaged in the surveillance that is carried out, we have seen examples of its effectiveness being diminished where too much knowledge of the technical details (such as alert logic and parameters, for example) is shared with this area of the business.

It is likely that further work will be undertaken in this area over the forthcoming years and we will be working with firms to establish effective surveillance operating models.

Defensive reporting of STRs
Firms are increasingly expressing concern to us on visits that they wish to avoid 'defensive' reporting of STRs. This is where the firm is unsure that the activity necessarily leads to a reasonable suspicion of market abuse, but adopts a cautious approach and submits an STR nonetheless. While we acknowledge this view, we have seen examples where firms have potentially set too high a bar for the 'reasonable suspicion' test. These have included instances where firms appear to have sought a level of evidence amounting to proof that market abuse has taken place, as opposed to reasonable suspicion that it may have done. Others have

included examples where firms appeared to focus their efforts on closing alerts, rather than undertaking an appropriate, balanced review. While we recognise the challenges of applying this test to complex scenarios, we would encourage firms to give careful consideration to how they do so (i.e. how they apply the test) and be cautious of seeking reasons not to submit. We are currently of the view that we receive little to no defensive reporting from the industry and, as stated in Market Watch 48, we believe that there is a general under-reporting across most asset classes. We have a programme of feedback in place for those instances where we believe a submitted STR may have not met the 'reasonable suspicion' test and firms can expect to hear from us if we believe this may be the case.

Suspicious transaction and order reports (STORs)
The EU's Market Abuse Regulation (Regulation EU/596/2014 – MAR) will further develop the requirements for firms and other persons to submit details of suspicious transactions – and now orders and attempted behaviours as well – to the FCA. We intend to supervise the STOR regime in much the same way that we currently supervise the STR regime, and urge firms to continue to consider the observations here, and in Market Watch 48, when designing the surveillance required under MAR.

The most obvious change for firms will be the introduction of a new form for STORs for use from 3 July 2016. This form will be provided within our CONNECT system, which is currently used for authorisations and approved persons applications. We will be issuing further communications regarding this between now and July.

In the meantime, we thank firms for their cooperation on our supervisory visits and we look forward to meeting more of you in the coming year.

Transaction reporting: A reminder to firms of their obligations under SUP 17 of the FCA Handbook

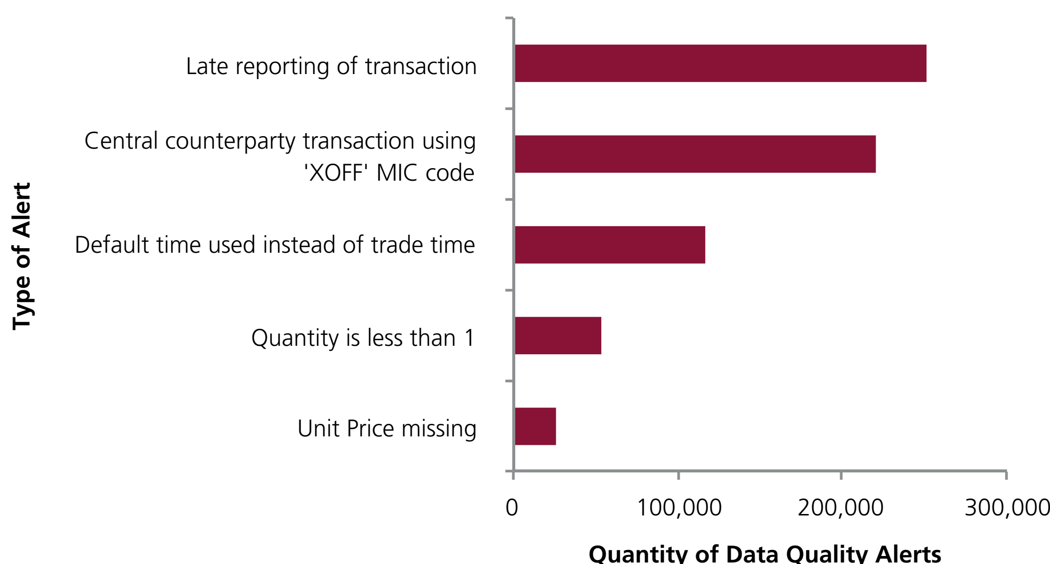
Firms are reminded of their obligation to submit transaction reports as per the requirements set out in SUP 17 and the Transaction Reporting User Pack (TRUP) 3.1 Section 4. Transaction reports should be complete and accurate (TRUP 3.1 section 4.1).

Transaction reports are an essential tool that the FCA uses to detect market abuse. Our ability to do this is directly affected by poor-quality data in the transaction reports that firms submit to us. Transaction reports containing poor-quality data also impact the work of other European Competent Authorities in this area, as a significant proportion of the transaction reports that we receive from firms are forwarded on to them via ESMA's Transaction Reporting Exchange Mechanism (TREM). Where appropriate, we also share the transaction reporting data with other regulatory bodies, such as the Bank of England.

Even though the transaction reporting regime under MiFID I is now well established, we continue to see some firms submitting transaction reports containing poor-quality data. The ability of firms to submit accurate and complete transaction reports is essential if they are to be in a strong position to meet the more complex requirements of MiFID II and MiFIR. In the interim period until the new regulations apply, we expect firms to provide accurate and complete transaction reports under the current regime.

To further monitor data quality, TMU carry out periodic sampling to monitor the quality of transaction reports submitted. As shown below in **Figure 1**, we continue to see high numbers of inaccurate transactions reported.

Figure 1: Transaction reporting – Top five data quality alerts for the five-day period 21–25 September 2015



Data quality alert	Description
Late reporting of transaction*	Where firms send transaction reports after T+1, which is the required timescale.
Central counterparty transaction using 'XOFF' MIC code*	Where the transaction was executed on any trading venue and the transaction is not an OTC derivative, the correct Market Identifier Code (MIC) must be provided.
Default time used instead of trade time*	The time at which the transaction took place in UK time should be reported, unless it is unavailable.
Quantity is less than 1*	This field must contain the volume (i.e. units) of the transaction.
Unit price missing*	This field should contain the traded price of the financial instrument.

***For clarification of the above alerts, please refer to SUP 17 and/or TRUP v3.1.**

Our commitment to ensuring that the quality of transaction reports remains unchanged and we continue to focus specialist supervisory efforts on this.

Key messages from the Final Notice against W H Ireland Limited

Summary

On 23 February 2016, the FCA issued a Final Notice[1] against W H Ireland Limited, an FCA-authorised firm. The Final Notice was, in part, in respect to breaches of Principle 3 of the Principles for Businesses in our Handbook, which requires a firm to take reasonable care to organise and control its affairs responsibly and effectively, including having in place adequate risk management systems. The firm was fined £1,200,000 and its Corporate Broking Division was restricted from taking on new clients for 72 days. Had the firm not settled with the FCA, the fine would have been £1,500,000 and the restriction would have been for 90 days.

The Final Notice was issued due to the firm's failure to put in place effective systems and controls to protect against the risk of market abuse occurring in a defined period in 2013.

Why this is important

The Final Notice makes clear that 'Market abuse is serious and undermines confidence in the integrity of the UK financial services sector. The first line of defence in the fight against market abuse is the systems and controls that firms have in place to protect against, detect and help prevent it, including comprehensive compliance oversight, robust governance, and adequate training.'

Generally, the UK market abuse regime applies to all persons, including all regulated firms. However, the messages in the Final Notice apply, in particular, to any regulated firm that has access to inside information; that trades for its proprietary account, and/or for the account of its clients; and/or that permits staff to undertake personal account dealing. Note that the situation at W H Ireland was particularly concerning because the firm's systems and controls showed deficiencies across a wide variety of business lines, increasing the risks of abuse both within the firm and externally.

Firms that undertake a broad range of business need to be particularly vigilant to the risks of market abuse. Risks are created by having access to inside information through relationships with issuer clients, internal research analysts, or large client orders, or by being wall-crossed by external advisers. These risks can be exacerbated by poor controls around proprietary trading, such as market making, staff personal account dealing, and client dealing.

Robust controls, such as strong information barriers, well-managed PA dealing policies, proprietary trading monitoring, and client trading surveillance can mitigate some the risks of abuse occurring.

Considerations for firms

Firms should have a good understanding of the risks that are relevant to their businesses, as well as strong controls for mitigating those risks. The weaknesses identified in the Final Notice should act as a catalyst for firms to consider whether their own controls are fit for purpose, as well as offering examples that regulated firms can use to assess their own systems and controls. Firms should also consider the recommendations made in the recent FCA review of how firms manage confidential and inside information.[2]

1 www.fca.org.uk/your-fca/documents/final-notices/2016/wh-ireland
2 www.fca.org.uk/your-fca/documents/thematic-reviews/tr15-13

Our increased focus on this issue
The FCA will continue to focus on firms' systems and controls to prevent market abuse. We see firms' controls in these areas as essential to our operational objective of ensuring the integrity of UK financial markets. We place as strong an emphasis on identifying weaknesses in regulated firms' controls as we do in pursuing market abuse.

Preparing for MAR
Looking forward, the new Market Abuse Regulation (MAR) applies from 3 July 2016, replacing the current framework under the Market Abuse Directive (MAD). A relevant example of a MAR obligation is that any person professionally arranging or executing transactions will be required, under Article 16 of MAR, to establish and maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions. Firms should ensure they are fully aware of their obligations under MAR and how these may differ from MAD, including but not limited to: the larger amount of instruments covered within the scope of MAR; the scope of the offences, such as the inclusion of attempts to commit insider dealing and market manipulation; and the inclusion of suspicious orders under Article 16.

It is the responsibility of firms to ensure that they understand the new requirements and are fully compliant by 3 July 2016.

What we will do if this problem persists
If we continue to find firms that fail to identify or mitigate risks associated with market abuse, or fail to report to the FCA instances where market abuse has occurred, then we will take stringent action against those firms. These actions could include penalties such as the fine and restriction that we have imposed on W H Ireland Limited.