

Market Watch

Newsletter on market conduct and transaction reporting Issues

June 2015 / No. 48

Contents

Trade volume advertising: Considerations for firms and individuals relating to risks of market abuse	P1
Our observations from Suspicious Transaction Reporting (STR) Supervisory Visits	P4
Direct Electronic Access (DEA) Pre-Trade Controls	P6

If you wish to join our email list to receive future editions, please contact us at market.watch@fca.org.uk

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

Trade volume advertising: Considerations for firms and individuals relating to risks of market abuse

Market participants have raised concerns to the FCA of firms publishing incorrect trading volume data in the equity market. This paper aims to highlight the possible market abuse risks related to this practice, and help firms and individual traders who are employed by a firm ('individuals') that advertise trading volumes consider these risks.

Policies for advertising trading volumes

The practice of firms and individuals publishing trading volumes is not new and the FCA is aware that some data platforms have issued guidelines for how trading volume should be measured and advertised. The FCA is not seeking to issue guidance in relation to this practice, nor is it seeking to comment on such existing guidelines. However we would like to draw the attention of firms, individuals and other market participants to market abuse considerations associated with this practice.

Firms and individuals should consider the policies of the data platform carefully, as there could be an assumption by others that by agreeing to have their volumes posted on such platforms, they will have agreed to the platform's policies. Market participants observing and acting on the advertised trading volumes will assume the firms are adhering to the data platform's policies for advertising trading volumes.

Market abuse considerations

When considering their approach to advertising trading volumes, firms and individuals should be aware of the market abuse offences described in sections 118(7) and 118(8) of FSMA.

Incorrectly advertised volumes could create false or misleading impressions as to the supply/demand of stock traded by a firm. Such false or misleading impressions could, in turn, encourage market participants to trade the stock through the firm. For example, where a market participant sees that a firm has traded a large volume in a given stock which results in a significant market share, they may infer that the firm is the most competitive entity for them to route future trades in that stock.

Where advertised volumes create false or misleading impressions, this could amount to market abuse under sections 118(7) or 118(8) of FSMA.

Industry feedback and FCA observations

The FCA has received a number of complaints from market participants, noting examples of firms appearing to have inflated their advertised trading volumes. However, some market participants have also pointed out that they generally do not rely on advertised trading volumes because they believe the methodologies for measuring and advertising trading volumes are inconsistent.

Perhaps because of this scepticism over the consistency of methodologies, market participants have rarely raised concerns that inflated advertised trading volumes might amount to market abuse. Nonetheless, firms and individuals should carefully consider if their methodology for measuring and advertising trading volume is appropriate and mitigates the risk of creating a false or misleading impression.

FCA comments on advertising methodologies

It is our understanding that firms have a number of options for the methodologies they can choose to adopt when advertising their equity trading volumes. These options can create inconsistencies in reported volumes between firms, and also within the firm if it uses different methodologies on different occasions.

We understand that some firms choose to advertise their trading volumes solely through automatic feeds which derive directly from the firm's trading software. These feeds are usually delayed and therefore during this time gap the market remains unaware of recent trading activity.

Other firms choose to advertise trading volumes using both automatic feeds and an element of discretion which allows traders to over-ride the automatic feed. This enables traders to immediately advertise any significant trading volume. In such instances, we understand that most firms rely on their traders to cancel the discretionary advertised volume once the automatic feed is advertised.

Why this behaviour matters

Firms and individuals advertising their trading volumes, whether through mainly automatic or discretionary feeds, may find it useful to consider the risks of market abuse which can arise from their advertised volumes and how best to mitigate against these risks.

Firms and individuals should be aware of the risks involved and ensure they appropriately mitigate these risks. They should also consider the FCA Principles for Businesses (PRIN) and the

Statements of Principle and Code of Practice for Approved Persons (APER), as well as any other regulatory obligations.

Considerations for firms and individuals

We recognise there are legitimate circumstances for advertising trading volumes.

Firms may wish to consider the following scenario:

Trader A has traded a large volume in shares of company X. Trader A's trading volume is normally advertised using automatic feeds from the firm's trading software, but in this instance Trader A believes it would be helpful for price discovery purposes to inform the market of the large trade immediately rather than wait for the automatic feed to be uploaded. Trader A over-rides the automatic feed and advertises the trading volume. As market participants become aware that Trader A has a significant market share in shares of company X, more trading volume is directed at the firm through Trader A. Trader A becomes increasingly busy and forgets that the advertised trading volume has now doubled to include both the discretionary volume advertised by him directly and the delayed automatic feed.

In the above scenario, firms and individuals may wish to consider the following, non-exhaustive, questions. These questions may assist in forming views of the risks of breaching FCA rules:

Firms

- Does the firm's trade volume advertising methodology comply with guidelines published by the data platform which facilitates the advertising?
- If the firm allows for discretionary over-rides for advertising trading volumes, is the firm comfortable with the systems and controls it has in place to ensure advertised trading volumes are accurate?
- What consideration has the firm given to whether its advertised trading volumes risk creating a false or misleading impression and how the firm mitigated these risks?
- Does the firm have any internal policies in relation to advertising trading volumes?
- Are traders trained on the firm's policies in relation to advertising trading volumes?
- Is the firm comfortable with its ability to monitor any breaches by its traders in relation to advertised trading volumes?

Individuals

- What consideration has the trader given to whether the advertised trading volumes risk creating a false or misleading impression and how he/she mitigated these risks?
- Has the trader considered how to mitigate the risks of advertising incorrect trading volumes?
- Has the trader considered how to mitigate the risks of creating a false or misleading impression?

Our observations from Suspicious Transaction Reporting (STR) supervisory visits

As discussed in previous editions of Market Watch, we have been undertaking a series of supervisory visits to a variety of firms in order to better understand and assess the way in which potential incidents of market abuse are being identified by authorised firms. This includes looking at how staff escalate their concerns to Compliance and how Compliance identifies potential incidents of market abuse through surveillance. Our visit programme continues and forms part of our ongoing STR supervisory work, however we consider it helpful to present some themes and observations from the visits undertaken in 2013 and 2014.

We continue to believe that STR submission is not consistent across all areas of the industry and that submission levels are too low in places. Our visit programme is not, however, seeking to lower the level at which reasonable suspicion lies and thereby reduce the reporting quality of the regime, nor do we wish to encourage defensive reporting. The quality of the STRs we receive is generally very good, although there are some firms who submit significantly fewer than their peers and some asset classes for which we believe surveillance is less developed and therefore incidents are being missed. It is our intention to ensure that the appropriate systems and controls are in place to ensure that potential instances of market abuse are identified. Additionally, we believe there may be cultural obstacles to the detection of market abuse in some asset classes and we have seen firms failing to adapt their processes to close these gaps.

The focus of our STR visits continues to be educational; however, remediation plans have been requested in a number of cases where we believe firms are at risk of breaching the requirements and further actions may be considered in particular cases. In all cases we will seek to work closely with firms to ensure improvements are implemented in a proportionate and appropriate manner. We continue to see the detection of market abuse as a partnership between the regulator and industry and it is important that we help firms, as the first line of defence against market abuse, understand our expectations. To that end, we set out some observations from our visits below.

Assessing the risk of market abuse

Firms may wish to consider undertaking a detailed assessment of the market abuse risks to which they are exposed before designing a surveillance programme. We have seen this approach produce effective results and note that some firms visited had considered, on a per asset class and per business section or desk level basis, the risk of each market abuse behaviour (detailed in the Code of Market Conduct and supplemented by ESMA Guidelines¹) occurring or being facilitated by that firm. Some firms have found it useful to utilise the experience and market intelligence of front office staff in the design of this risk assessment. For a number of firms, this work has allowed proportionate and appropriate surveillance to be designed and also highlighted where gaps exist that may require further development or manual surveillance techniques.

¹ Systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities [ESMA/2012/122]

Front office escalations

A number of firms we have visited have under-invested in the training provided to their front office staff, leading to a low level of understanding and commensurately low reporting of potential incidents of market abuse. Instead, where possible, firms may wish to consider incorporating use of online theory with face-to-face discussions of what suspicious transactions would look like into their staff training frameworks, as we have seen some firms use this approach with effective results. We have also seen several cases of a more generic approach being used, with bond traders, for example, undergoing training that focused on examples of abuse in the equity markets. This generic approach may limit effectiveness due to the lack of relevance of the training and firms might consider the potential benefits of a more tailored approach to staff training, incorporating different asset classes and how market abuse may present itself to a variety of roles within the firm.

At the point where a member of staff does identify suspicious behaviour, we have observed a number of firms where the escalation is excessively formalised or goes to the wrong person. In contrast, some firms have relatively informal, but documented, reporting to a member of the Compliance team, Surveillance team or line of business Compliance with more effective results. In those instances where undocumented reporting to heads of desk or business management was observed, it has led to conflicts of interest, lack of audit trail and potentially inadequate challenge on decisions not to submit STRs.

Some firms we visited use management information to identify desks or sectors of the business that are potentially underperforming in their STR reporting obligations. In many cases we observed this to be an effective form of analysis and firms may wish to consider this as a way to target and refine their market abuse training.

The integrity of data used by surveillance routines

On a number of our visits, we identified concerns around the integrity and completeness of the data being used by firms for their surveillance routines. This has adversely affected the quality of the surveillance performed and led to potentially suspicious behaviour being missed.

Data validation routines are in place at some firms to good effect, and in some cases surveillance analysts are empowered to challenge the data they are getting and escalate concerns internally where necessary. In addition, we have seen a number of firms who include surveillance in their internal audit programmes, which has led to some firms being able to self-diagnose data problems from internal audit assurance.

Calibration of surveillance systems

We have found that in-house designed surveillance systems and 'off-the-shelf' surveillance systems can be equally effective when used appropriately. In particular, we have seen simple surveillance routines involving spreadsheet software used effectively in smaller firms. One of the most important aspects of a successful surveillance system appears to be the manner in which it has been implemented. Some effective surveillance programmes have involved significant and careful calibration of both the alert parameters and alert logic based on surveillance officers' experience of that firm's trading patterns and clients. Constant refinement and testing of the alerts or surveillance routines has proven important to achieve effective and proportionate surveillance. This has been used by firms to ensure that the alert is correctly targeted (for example, that an alert named 'Layering' actually looks for layering) and has ensured that false positives are minimised as much as possible without eliminating true positives.

Some firms monitor the number of alerts generated by surveillance systems on a per alert type basis to ensure that the alert generates an appropriate number (for example, an alert that generates nothing in one year or generates thousands of exceptions per day may be an indicator that the alert is not set up using the correct logic or the appropriate parameters.)

Once surveillance routines are carried out or alerts generated, we have seen some firms ensure that analysts are given access to a wide range of the firm's data and are empowered to investigate each alert fully, with positive results. The assessment of each alert in line with clear systems and procedures appears to be linked to effective analysis, alongside an audit trail and a clear process for closure including challenge and quality assurance where necessary. In other firms, we have seen an over-emphasis on the importance of closing alerts daily rather than providing clear guidelines for escalation and, ultimately, submission to us where necessary.

In some firms we have seen heavy use of random sampling and apparent over-reliance on 'out of the box' alert calibration. In addition we have seen a number of firms who do not set clear parameters for their surveillance. Whilst we acknowledge the importance of utilising the experience and judgement of surveillance analysts, our experience has suggested that these techniques have led to inconsistently applied surveillance in a number of instances and potentially suspicious trades have been missed.

Finally, we have seen a number of firms where even basic surveillance has not been undertaken beyond equity products. The firms who appear to conduct the most appropriate and effective surveillance tend to use a market abuse risk assessment to identify where gaps may lie and as a result have implemented development and improvement programmes in those areas at highest risk.

Future developments

The EU's Market Abuse Regulation (Regulation No 596/2014 of the European Parliament and of the Council of 16 April 2014) will further develop the requirements for firms to submit details of suspicious transactions, and now orders, to the FCA. Much of this develops and expands upon existing ESMA guidance. As and when these requirements are finalised we will develop our supervision and help firms in understanding the new regime. In the meantime, we thank firms for their cooperation on our STR supervisory visits and look forward to productive meetings in the future with other firms.

Direct Electronic Access (DEA) pre-trade controls

In Market Watch 46 we detailed the events that led to a spike in the intraday price of HSBC shares. Following further short term share price volatility incidents we undertook a review of pre-trade controls for cash equity DEA trading. The review encompassed Direct Market Access (DMA) and Sponsored Access (SA) trading and included a sample of Investment Banks, Agency Brokers and Trading Venues that offer DEA. We have set out below our high level observations which may provide an opportunity for firms to review the systems and controls around their automated and DMA trading.

Review objectives

The European Securities and Markets Authority (ESMA) guidelines on systems and controls in an automated trading environment² note that it is important that trading platforms and their members/participants retain control of and closely monitor their systems to minimise any potential disruption caused by these third party users of DMA/SA. This project sought to review the level of pre-trade controls currently available for Direct Electronic Access (DEA) equity trading in the UK.

Findings

Based on analysis of the documentation requested, and on-site visits conducted during this review, we have split our findings into three major areas:

- Pre-trade controls.
- Control setting and amendment procedures.
- On-going monitoring and incident surveillance.

Pre-trade controls

All firms included in our review demonstrated pre-trade controls broadly in line with the relevant ESMA guidelines. However there was a significant variance in level of sophistication of these controls. Firms with less sophisticated controls may be more at risk of not complying with the ESMA guidelines. More sophisticated controls observed during our review include:

- Symbol (stock) specific criteria such as percentage of average daily volume (ADV).
- Aggregate/Exposure controls that are symbol (stock) specific.
- Aggregate/Exposure limits broken down into separate time segments (for example 30-60 minute slots)
- Participation (percentage of traded volume) alerts.
- Automated restrictions on non-priced (market) orders.
- Market impact controls.

It is important to note that we have observed market incidents (for example price spikes leading to a temporary suspension of trading for all participants in a particular stock) which could have been avoided if these controls had been implemented.

Control setting and amendment procedures

Pre-trade controls will only be effective if the parameters are set at the appropriate level. The process for setting control levels varied considerably in the firms we reviewed. Some firms demonstrated a greater sophistication in control parameter setting, considering both

² www.esma.europa.eu/system/files/esma_2012_122_en.pdf (February 2012)

the expected market impact and the client's anticipated trading activity. However we also witnessed firms where controls were clearly set at inappropriate levels, and/or the same levels were applied across multiple clients without due consideration.

Some participants noted that amendment procedures should not become so burdensome that control levels are set deliberately very high or very low to avoid having to follow the amendment procedures. We observed some examples of this setting of very high or low control levels when a control could only be amended overnight, as a result the control was never triggered and was ineffective. In contrast we observed controls remaining effective throughout an amendment process when pre-arranged extensions to parameter levels could be approved by the trading/client coverage desks under specific conditions, for example during periods of market volatility such as closing auctions and index rebalances. Where changes extended beyond pre-agreed levels, the issue was escalated to senior management and sign off was required from Compliance and Risk functions.

Control monitoring and incident surveillance

In many circumstances pre-trade control breaches occur at times of market stress and volatility, so suitable monitoring and incident surveillance procedures need to be able to function effectively at all times. During our review we observed examples of effective real-time and post trade monitoring:

- Dedicated real-time monitoring teams with detailed knowledge of control parameters and expected client trading activity.
- Controls with alerts in place to provide warning before control levels are breached.
- Clearly defined procedures to ensure monitoring is performed in a time sensitive manner and with suitable escalation and recording plans.
- Formal reviews of Management Information including control breaches and limit utilisation.

However we also observed examples where control breaches and amendments were not recorded and/or audit trails were not readily available. In these cases it was much more difficult for firms to assess the effectiveness of their controls.

On-going work

We will continue to monitor the effectiveness of DEA controls at authorised firms as part of our risk based supervisory approach. This may include proactive (firm specific) deep dives, broader thematic studies of groups of firms or sectors, and investigations into the causes of market disruptions. As part of the finalisation of MiFID II ESMA is currently drafting Regulatory Technical Standards which formalise and expand on the contents of the existing guidelines on systems and controls in an automated trading environment. When these are finalised we will develop our supervision in the light of any changes.