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Contents

Commodities Trading Thematic (CT) Review P1

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Commodities Trading Thematic (CT) Review

Following recent changes in the structure of the commodities trading markets, with a number of previously active Investment Banks reducing their participation, we reviewed 12 firms, including brokers, interdealer brokers (IDBs), and commodities trading firms.

The review focused on firms trading and broking across the Oil, Energy, Metals and Soft commodities sectors and considered the adequacy of their front office and market abuse controls. We also reviewed the governance arrangements, culture and processes in place in relation to the commodities markets to assess each firm's ability to manage the impact of these structural changes on their businesses. Here, we set out our high-level observations. Although the review included a sample of 12 firms, these findings will be of interest to all firms in the commodities markets.

Key messages

- The effectiveness of the controls, management and governance structures we assessed varied widely across the firms. We observed both good and poor practice across the sample, but noted that the more positive practices were typically demonstrated by firms with cultures that fully recognised the potential risks from their front office activities.

- Many firms had not embedded the lessons learned from recent market abuse cases (such as LIBOR, FX and Gold). On this point, our benchmark thematic work also urges firms to take note of the outcome of recent enforcement cases[1]. In some firms we found complacency towards the risk of market abuse. Many firms believed that commodity markets were 'too deep, too liquid, and there are too many participants' to be manipulated.

1 www.fca.org.uk/news/tr15-11-oversight-controls-in-relation-to-financial-benchmarks, p.8, 1.29

- Most firms had not carried out a Code of Market Conduct (MAR1) risk assessment and therefore could not demonstrate they had adequate monitoring and surveillance across the full range of market abuse risks to which they were exposed. In addition, many firms could not demonstrate effective procedures to identify suspicious transactions and escalate them to the FCA in the form of Suspicious Transaction Reports (STRs). Only 2 of the 12 firms in the sample had submitted STRs relating to commodities trading, although many characterised events and market behaviour that may have required submissions.

- Although some firms had embedded risk, such as risk analysts and risk systems on the trading desk, few firms demonstrated intraday management information (MI) or risk monitoring. We also observed lower levels of monitoring and management of prudential risks such as credit, liquidity and market risk at commodity trading firms than at some firms outside of this sector.

General findings

Business model and governance

Generally we found straightforward and focused business models at the firms we visited and, with some exceptions, firms demonstrated effective management and governance structures with formal committee structures and clear escalation procedures. However, in other firms we found less effective governance arrangements, for example, informal committee structures and arrangements, unclear escalation procedures and no formal records of board or committee debates or decisions. These firms were also less able to demonstrate that senior management had clear sight and control of the conduct risks presented by the front office in terms of conflicts of interest or more serious issues around market abuse, such as a rogue trader, or potential market manipulation.

Compliance function and firm culture

As well as assessing front office and market abuse controls we also considered the overarching framework that underpinned those specific controls. Most firms could demonstrate to us that they had appropriate staff, and systems and controls structures in the Compliance and Internal Audit functions. In our review, the best results were achieved by those firms where Compliance was integrated with the front office and had a permanent physical presence on the trading floor; at these firms we observed proactive risk identification with Compliance participating in the flow of information and traders able to receive guidance on acceptable market conduct.

Compliance functions which attended regular trader/broker meetings were able to show us they had good awareness of current trading issues and market abuse risks. However, a few firms had separated their Compliance functions from the trading/broking operations and therefore could not demonstrate effective management of their market abuse risks, in comparison with their more proactive peers who could.

In most firms, experienced traders oversaw the junior traders on their desk, enabling them to transfer their knowledge and expertise. This was also an effective means of embedding the firm's culture. However, the practice could also be counterproductive where experienced traders did not embrace the tone set by senior management, or did not recognise market abuse risk as being relevant to their markets.

We identified positive examples of compensation being directly linked to cultural behaviours of the front office. At some firms we saw that variable compensation could be linked to completion of training, including market abuse training, language used in communication and the treatment of colleagues. Failure to complete compulsory training, or instances of poor conduct in the work place, resulted in reduced compensation. These firms believed they derived a benefit from incentivising individuals to consider their behaviour and by sending a strong message about the firm's culture.

Front office risk controls

Although some firms had embedded or integrated risk functions on the trading desk, few firms demonstrated intraday MI and risk monitoring despite the level of intraday event risk in some commodities markets. Compared with some Investment Banks, whilst recognising that most of the operations in our sample were smaller, we nonetheless found a lack of monitoring and management of prudential risk. Credit risk was usually assessed but left un-hedged with little management of individual or portfolio exposures, and firms that had not established Credit Valuation Adjustment (CVA) desks were less able to demonstrate effective management of credit risk.

Similarly, some firms did not include stress testing and scenario analysis in their assessments of liquidity risk. As a result these firms were less able to give assurance on the robustness of their controls. Market risk was usually given consideration, but on a portfolio basis little attention was paid to concentration risks which, in the event of stressed market conditions, could result in large financial pressures and liquidity risks.

Market abuse controls

We are concerned that some firms believe commodity markets are 'too deep, too liquid, and there are too many participants' to be manipulated. In some firms this view was held both by front office staff and senior management. In addition to being misguided, we found these views surprising in light of recent cases of manipulation in other deep and liquid markets, as well as historical market abuse cases in the commodities markets. Effective market abuse controls were identified at a few firms within both the training programmes that incorporated topical examples of market abuse, and surveillance systems that used both the firm's trading experience and examples from the market. Where training programmes were both compulsory and relevant, firms could demonstrate they had taken appropriate steps to promote good front office conduct.

At the majority of firms, trader/broker understanding of their responsibilities on use of inside and market sensitive information was poor. For example, we saw instances where trading

around infrastructure outages and firm equity holdings was conducted without pre-trade checks to ensure it was appropriate to trade on the information received.

With a few exceptions awareness of market abuse risk was poor. This was demonstrated by the lack of awareness of market abuse cases specific to the commodities markets, ignorance of firm obligations in relation to the FCA's Suspicious Transaction Report (STR) regime and unwillingness to consider how recent market manipulation cases such as those in LIBOR, FX and Gold fix could relate to the markets they traded.

Firms that did not fully recognise the risks of market abuse were more likely to employ inappropriate surveillance, in terms of the choice of automated or manual systems, calibration of systems and frequency of monitoring. Overall, there was little order level monitoring, making it difficult for firms to demonstrate effective monitoring for market manipulation, and we often found surveillance being done on an inadequate or poorly targeted sample basis.

Most firms' communications surveillance captured Instant Messenger and recorded lines, but did not monitor these on a systematic basis. We observed more effective monitoring at firms where sampling was targeted at higher risk periods (such as at contract expiry or around important announcements) and at higher risk individuals.

Many firms had inadequate STR procedures, with typically no written procedures and a lack of clarity on what constitutes an STR. The number of STR submissions within the commodities sector is low in comparison to other asset classes, which may indicate that potential suspicious transactions are not being appropriately reported. STRs are an important intelligence asset to the FCA as they allow us to review instances of potential market abuse more effectively. In addition, individual STRs from firms can also be significant as, when combined with STRs and information from other sources, they help to create a complete picture.

Ongoing work/future developments

The Fair and Effective Markets Review (FEMR)[2] set out 21 recommendations aimed at raising standards, including in commodities markets, promoting forward-looking conduct risk identification and mitigation, and improving the quality of trading practices. We will continue our supervisory work on commodities trading firms, taking into account the key findings of this review. Our supervisory work will develop as the impact of recent European legislation takes hold. With the introduction of MiFID II[3] and expanded powers under MAR, more commodities trading firms are likely to be brought into the regulatory perimeter.[4]

2 www.bankofengland.co.uk/markets/Documents/femrjun15.pdf

3 Markets in Financial Instruments Directive 2 (Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014)

4 Market Abuse Regulation (Regulation No 596/2014 of the European Parliament of the Council of 16 April 2014)