

Market Watch

Newsletter on market conduct and transaction reporting issues

October 2019

Contents

Personal account dealing	P1
Transaction reporting	P7

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

Introduction

In this Market Watch, we share our concerns about personal account dealing (PAD) - where employees of an authorised firm trade for themselves rather than for clients. We set out the findings from our study into PAD activity, policies, processes and systems and controls in a sample of wholesale broking firms. We also share some observations on transaction reporting, following previous Market Watch newsletters on this.

Personal account dealing

Background

We require firms to establish appropriate rules governing PAD undertaken by relevant persons (including employees and tied agents). These are set out in our Conduct of Business Sourcebook [11.7](#) and [11.7A](#).

These rules create a control framework for firms to minimise the risk that such trading:

- conflicts with the interest of their clients
- results in market abuse including front running client orders
- or creates a conflict between employees' personal interest and their regulatory obligations to report suspicious transactions or orders

To achieve effective compliance, firms need to understand the PAD risks posed by their business models, design clear policies and processes around those risks and develop a culture where adherence to their rules is the norm. When breaches of PAD policies do occur, firms need to investigate them and, where appropriate, take disciplinary action.

In a speech in February 2019, in the context of the 5 Conduct Questions approach, we highlighted how important it is that firms can identify their market abuse-related conduct risks to ensure they have effective systems and controls in place. We also highlighted the risk of individuals using inside information to trade on it for their personal account and the importance of having effective controls to manage inside information within the firm (we reiterated this in Market Watch 60).

In addition, we highlighted that the Senior Managers and Certification Regime (SM&CR) requires individuals to comply with Conduct Rule 5 – ‘observing proper standards of market conduct’.

Approved persons and employees covered by the SM&CR must act with integrity and observe proper standards of market conduct when performing their functions, including complying with their firms’ PAD policies and processes.

Failing to adequately assess the conduct risks that PAD may pose, or to have adequate systems and controls in place or to train staff to observe appropriate standards of market conduct may leave a firm or its staff exposed to raised risks of regulatory action.

Consequently, we expect firms to have appropriate policies, training, oversight, systems and controls so they can manage the risks inherent in PAD, to ensure that staff observe appropriate standards of market conduct in adherence with our rules.

Our preliminary reviews and investigations

We identify and pursue suspicious trading by analysing suspicious transaction and order reports (STORs) and transaction reports (which clearly identify individuals who have traded).

Trading carried out by an individual working for an FCA-authorized firm (or a person closely connected to them) can appear suspicious, eg because it occurs shortly before a price sensitive announcement. When this happens, we may prioritise that trading for further review. A routine step involves engaging with the firm to understand more about the trading, including whether it complied with the firm’s PAD policy.

Individuals who breach their employer’s PAD policy should be aware that their trading may come to their employer’s attention as part of an FCA information request and may result in a formal investigation.

We are concerned how often we are seeing apparent breaches of PAD policies and the issues which have come to light as a result, including:

- Employees in front-office roles not appearing to understand their firm’s PAD policy despite having signed attestations that they have read, understand and will comply with those policies.
- Firms and employees considering that ignorance of PAD policies provides reasonable mitigation for PAD in breach of that policy.
- Employees – including front office, compliance and surveillance - deliberately not declaring external accounts to their employer and/or circumventing requirements. This includes operating undeclared accounts in the names of relatives where trades are executed without any input from the named account holders.

- Employees trading in breach of the relevant policies including:
 - Trading in products, such as spread bets on the firm's own shares, when the firm's policy specifically prohibits this.
 - Dealing in conflict with their professional decisions/ recommendations. For example, research analysts trading against their own recommendations, or fund managers buying a security they have advised their fund to sell.
 - Following client orders. If client orders subsequently appear suspicious, both employees copying those orders and the firm may be compromised when considering escalating concerns. We have highlighted this as a particular risk in a recent [speech](#).
 - Front-running of client orders.

Additionally, firms have submitted STORs about suspicious trading conducted by their own employees on personal accounts, which also happened to be in breach of the firm's PAD policy. In these cases it is not evident that all firms take appropriate actions after identifying this behaviour, such as investigating, considering how to mitigate the risks arising from those employees, or taking disciplinary action against employees in breach of their firm's PAD policy.

Why this matters to firms

Such activity raises questions about whether the policies in place at firms are meeting the objectives of the PAD rules and wider regulatory obligations including whether:

- firms are managing conflicts appropriately
- firms are managing the risk of market abuse being undertaken by their staff appropriately
- firms have the appropriate processes for managing client confidential information
- firms adequately manage their obligations to identify and report suspicious transactions and orders
- individuals with responsibility for overseeing PAD systems and controls are complying with their obligations

What firms should consider

A firm should consider the following when designing its PAD policy.

- Where PAD creates conflict of interest or market abuse risk within its business model.
- How such risks can be adequately mitigated. This should include identifying if PAD of any sort, by front office and compliance staff in particular, presents risks that it cannot adequately mitigate within its business model.

- Given the easy access that employees have to a range of markets for PAD, including CFD and spread betting markets which are open round-the-clock, what effective monitoring and control of PAD it could do.
- How it ensures that employees are aware of their obligations.
- The appropriate degree to which it should rely on employees acting with integrity and following internal procedures and what level of post-trade monitoring of PAD activity is necessary to ensure employees comply with policies.
- What appropriate processes should be in place for assessing PAD requests and/or notifications submitted by employees so the firm can operate appropriate control.
- How such post-trade monitoring feeds into identification of potential suspicious activity which the firm can review and, if necessary, report to the FCA.
- Whether senior managers are leading by example when engaging in PAD and act as advocates of strict compliance with the firm's PAD rules.

Case study: assessing PAD activities and controls at wholesale broking firms

We recently carried out a study of PAD activity and controls at some wholesale broking firms. This was part of our assessment of the extent to which firms have incorporated recent changes in the market abuse regime into the way they do business.

Brokers receive confidential client information including inside information. Our rules, COBS 11.7 and 11.7A, as applicable, require broking firms to have suitable policies and processes to control and monitor PAD by employees. This is to minimise conflicts of interest and the risk of market abuse.

We reviewed PAD policies and processes at a selection of firms and combined this with an analysis of associated quantitative data on PAD activity by employees. The data included the number of PAD applications, trade volumes and the types of products and markets traded and the number of refusals, policy breaches and STORs submitted by firms relating to PAD. While the study is specific to wholesale broking firms, the findings can be applied beyond that sector.

Our findings – wholesale broking firms

We found the way in which firms control and monitor PAD varied substantially in terms of practice and standard. We have concerns that some firms may not have established appropriate PAD rules and processes in line with COBS11.7 and 11.7A, as applicable.

Many firms require employees to sign regular attestations confirming compliance with PAD rules. But this is not always accompanied by proper arrangements by the firm itself to monitor and control PAD that may be in breach of the policy.

A common control is for firms to require employees to obtain pre-approval on all PAD trades. Others allow PAD without pre-approval, though may place restrictions where it involves instruments that are traded by the employee on behalf of the firm, or its clients.

All the firms in the sample required employees to submit PAD trade details and some require copies of contract notes. Some firms reported high volumes of PAD and others virtually none. Low PAD volumes may indicate that not all trades are being reported by employees.

We saw instances where individuals were trading very frequently for their own account, including in extreme instances, several times per day. Some firms have rules which limit the number of PAD trades that employees can undertake. Firms said this reduces the risk that frequent PAD by employees might impede their ability to carry out their function and to serve clients' best interests.

The number of PAD breaches proactively identified by firms sampled was generally low and none had submitted a STOR relating to PAD in the past year. This was surprising (and likely indicative of weaknesses in culture and controls) as other types of firms regularly do submit STORs about PAD.

We also found significant differences in the way, and degree to which, firms undertake pre- and post-trade analysis of PAD activity. Some firms look for indicators of insider dealing, such as price movements, news and corporate actions in the relevant instruments traded. Others cross-reference PAD trades with those of clients in a specified window around the PAD trade date. One firm downloads PAD trades to its market abuse surveillance system to monitor them alongside client trades.

Our overall concerns – wholesale broking firms

We are concerned that some firms may not be operating according to the rules set out in COBS 11.7 and 11.7A. We will be requiring appropriate action to be taken in specific cases.

We are generally concerned that firms in this sector have not identified or managed the PAD risks or conflicts of interest specific to their business model adequately. This may stem from a culture which has not sufficiently identified the potential for harm to clients or market integrity caused by inappropriate PAD practices. The absence of pre-approval for PAD trades, the low number of identified breaches and the absence of STOR submission within the sample of firms may indicate a lack of effective monitoring and management of risks.

That said, we are encouraged by specific practices taken at some firms, which had designed proportionate and effective policies, controls and oversight to manage the risks in their business.

Next steps for all firms

Firms should consider the points raised here about PAD and the requirements set out in COBS 11.7 and COBS 11.7A. They should also look at our expectations of approved persons set out in the APER Statements of Principle and Code of Practice for Approved Persons and the new Code of Conduct Rules under the SM&CR.

Firms should assess how they manage conflicts of interest and the risk of market abuse and the policies and processes that they have in place for managing PAD by employees. This includes how firms tell staff about their obligations and the need for all employees to behave with integrity. Training should be designed to ensure compliance with the firm's policies.

In addition, firms should consider how they can monitor PAD by employees. Where they identify areas of concern, we expect them to revise their arrangements. Firms need to work out how serious any breach was, assess the requirements of Principle 11 of the Principles of Businesses, and consider if they should inform the FCA.

Rules to consider

A number of rules and regulations underlie our oversight of the processes adopted by firms to control and monitor PAD by employees:

1. The Market Abuse Regulation
2. COBS11.7 and COBS11.7A set out the requirement for firms to establish appropriate rules governing personal account transactions undertaken by managers, employees and tied agents.
3. The Markets in Financial Instruments Directive (MiFID II).
4. FCA Principles for Business
5. APER 4.1. Statement of Principle 1. An approved person must act with integrity in carrying out his accountable functions.
6. APER 4.2 Statement of Principle 2. An approved person must act with due skill, care and diligence in carrying out his accountable functions.
7. The extension of the SM&CR, which is due to come into force in December 2019, places a statutory duty of responsibility on every senior manager. Senior managers can be held accountable for breaches of the FCA's rules in their area of responsibility if they did not take reasonable steps to prevent the breach from occurring. In addition, all employees (not just those approved by the FCA) other than ancillary staff must comply with a set of Individual Conduct Rules (COCON 2.1). These replace the Principles for Approved Persons and cover regulated and unregulated activities per COCON 1.1.6 to 1.1.7 (R).

Transaction reporting

Transaction reports help us protect and enhance the integrity of the UK's financial system by providing information which might allow us to identify potential market abuse and financial crime. Firms must have systems and controls in place to ensure their transaction reports are complete and accurate. If firms do not report their transactions accurately, market abuse may be hidden.

In [Market Watch 59](#), we highlighted common errors observed in transaction reports. Our ongoing monitoring of transaction reports and engagement with firms has led us to identify further data quality issues.

What your firm needs to do

Investment firms, trading venues and ARMs should note the following observations and review transaction reports to ensure the information is complete and accurate.

Reporting transaction prices

While many firms have taken steps to ensure that RTS 22 Field 33 (price) is reported correctly in the major currency (e.g. pounds), we have identified errors in other price-related fields. For example:

- Field 34 (price currency) is reported inconsistently with the currency in which Field 33 (price) is expressed.
- Field 46 (price multiplier) is reported inconsistently with the values provided in Field 30 (quantity) and Field 33 (price), or populated with a value that is not an accurate representation of the number of units of the underlying instrument represented by a single derivative contract.

These inaccuracies can lead to a misleading representation of the transaction, limiting our ability to carry out effective surveillance for market abuse.

Unique national identifiers

We continue to see inaccurate reporting of national identifiers. This includes where a 2nd or 3rd priority identifier (as defined by RTS 22 Annex II) is used to identify a natural person where a 1st priority identifier is available. We also see firms reporting default identifiers and using the same default value to identify multiple individuals.

These observations were not limited to the identification of clients, but included persons responsible for the investment decision within a firm (Field 57) and persons responsible for the execution within a firm (Field 59).

Buyer and seller decision makers

Field 12 (buyer decision maker) and Field 21 (seller decision maker) only apply where:

- the client is the buyer or seller and the investment decision is made under a discretionary mandate, or
- the buyer or seller has granted a power of representation

We have identified firms misreporting these fields by mirroring the contents of the buyer and seller fields. Other firms fail to populate the decision maker fields where it would generally be expected; for example, where an asset management firm is acting under a discretionary mandate on behalf of a fund and identifies the fund as the buyer or seller. We have also noted investment firms identifying a fund as the buyer or seller where transmission is not taking place (within the definition of RTS 22 Article 4) and we would instead expect to see the fund management firm identified.

Executing entity identification code

Our monitoring for transaction report data quality includes surveillance for transaction reports that have not been submitted. In Market Watch 59, we highlighted that some market participants had incorrectly populated Field 4 (executing entity) with the LEI of the broker they forwarded an order to, instead of their own LEI. As a result, we were unable to identify transaction reports from those market participants.

We continue to see firms failing to populate Field 4 (executing entity) with their own LEI where they are executing a transaction within the meaning of RTS 22 Article 3. Some firms have incorrectly reported this in Field 6 (submitting entity). Where the transaction report is submitted by an ARM, Field 6 (submitting entity) must be populated with the LEI of the ARM.

Misuse of the aggregate client account

The aggregate client account (INTC) is a convention used in transaction reporting to provide a link between the market side and client side of a transaction. We have identified firms misusing the aggregate client account by using the INTC convention to report order(s) for one client executed in multiple fills. Other firms have reported flows in and out of the aggregate client account that do not net off on the same business day. The aggregate client account should not be used for any other purpose than set out in the applicable guidelines.

Indicator fields

Firms have misreported fields 61, 62, 63 and 64 with potentially default values. Examples include Field 62 (short selling indicator) being universally reported 'UNDI' (information not available), and Field 64 (commodity derivative indicator) being populated 'false' for transactions executed in financial instruments that are not commodity derivatives. Field 64 should be left blank in this scenario. The indicator fields should be populated in accordance with the requirements in RTS 22.

Methods and arrangements for reporting transactions

In Market Watch 59, we highlighted the requirement in RTS 22 Article 15(2) for firms to notify us promptly when they identify any error or omission in a transaction report. We also highlighted that firms must conduct regular reconciliations of front office trading records with data samples provided by us (RTS 22 Article 15(3)).

Many firms have made positive steps to comply with these requirements. But some continue to rely on data samples provided by their ARM for their transaction report reconciliations. Other firms choose to delay notifying us when they identify errors and omissions, or do not think they need to where transaction reporting is outsourced to a third party. This is not consistent with our expectations or the requirements in RTS 22.

There is more information about transaction reporting on our website at: www.fca.org.uk/markets/transaction-reporting. You can also contact the Markets Reporting Team at mrt@fca.org.uk.