Financial Conduct Authority

Market Watch

Newsletter on market conduct and transaction reporting Issues

September 2016 / No. 51

Contents

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

Observations from Market Maker Review

In Market Watch 50 we highlighted our increased focus on firms' systems and controls to prevent market abuse. As an example of this we have recently completed a review of the market abuse systems and controls currently employed at several firms that engage in market making activities.

The review included a sample of firms that are registered market makers in small and mid-cap equities and considered the adequacy of their trading and market abuse controls. Many of the firms included in our review undertake a broad range of activities which can give rise to conflicts of interest and, as we stated in Market Watch 50, these types of firms need to be particularly vigilant in identifying and mitigating potential market abuse risks. Such risks can arise by having access to inside information through relationships with issuer clients, internal research analysts, large client orders, or by being wall-crossed by external advisers.

Here we set out our high-level observations. Although the review focused on small and mid-cap equity market makers, these findings will be of interest to all firms undertaking market making activities.

Project findings

The review focused on four key areas:

- market abuse risk awareness
- information barriers
- wall-crossing procedures and Insider lists
- ongoing monitoring and surveillance

These findings are general and based on observations from across the firms included in our review.

Market abuse risk awareness

Market abuse is a key risk for all the firms in our review and clearly the ability to identify these risks is very important in ensuring the most effective and robust systems and controls are in place. We found the level of market abuse awareness varied considerably within the firms in our review. Generally, we found that members of firms' Compliance teams were aware of the key market abuse risks within the business and could articulate them clearly. However, during conversations with senior management and members of the trading/market making teams the level of awareness was inconsistent and generally below our expectations.

In our recent report on the flows of confidential and inside information (TR15/13) we highlighted the importance of employees at all levels understanding their role in controlling flows of confidential and inside information and making this an integral part of how they carry out their work. In addition, we noted that we expect to see business heads acting in a supervisory capacity taking responsibility for controlling flows of information, with appropriate challenge and monitoring from the second and third lines of defence.

Regular risk assessments are clearly important in mitigating the risks of market abuse. Some firms in our review conducted detailed assessments of market abuse risks that included a comprehensive list of the relevant risks and the key responsibilities for managing and mitigating these risks, including the controls employed to achieve these goals. It important to note that firms who were not conducting regular market risk assessments had difficulty in demonstrating that effective controls were in place.

Information barriers

All the firms in our review confirmed that the maintenance of effective information barriers was essential to mitigate the risks of market abuse including insider dealing and the unlawful disclosure of inside information. This is particularly important where firms that have multiple information barriers in place, which may not always be separated by physical barriers.

The firms included in our review were able to clearly articulate and demonstrate the information barrier between their corporate finance/investment banking operations (private side) and the rest of the business (public side). Indeed, in all cases this was a physical barrier with restricted access. However, other information barriers were less well defined. For example, sales and sales-trading staff often sit within close proximity to the market making team. While this is understandable given their close working relationship it also poses significant challenges in maintaining effective information barriers.

We also noted circumstances during our review where senior management, often classified as Permanent Insiders, were situated (or had an additional desk) within close proximity to the market making desk, and had access to market makers' trading book positions. This is clearly a situation in which conflicts of interest could arise.

In order for information barriers to operate effectively they need to be clearly defined and understood. In our review, firms that physically segregated individuals or teams that regularly have access to confidential or inside information were able to demonstrate more effective controls. However, where this is not possible, firms might consider taking extra steps to ensure the information barriers are properly managed and maintained. As noted in the 'Fair and Effective Markets Review' published in June 2015[1] this could include specific training for staff operating in these areas and ensuring Compliance representatives are properly integrated with front line operations to improve manual surveillance capabilities and information management.

Wall-crossing procedures and Insider lists

The level of documented wall-crossing procedures was generally poor across the firms in our review. This is particularly concerning given the significant number of circumstances where wall-crossing was undertaken. We would draw attention to Article 11 of the Market Abuse Regulation (MAR)[2] which includes procedural and record-keeping provisions in relation to both wall-crossed and non-wall-crossed market soundings.

Some firms in our review used the Compliance team as 'gatekeepers' in all wall-crossings. In these circumstances the Compliance team would judge whether the wall-crossing was necessary, who was the correct person to wall-cross and finally the most appropriate time to do this. We found this to be the most effective approach we observed, as it allows firms to centralise the wall-crossing process, reduces the risks of inadvertent wall-crossing, and provides a more consistent approach.

It should also be noted that during our analysis on specific transactions we observed several examples where details recorded on insider lists were either inaccurate or, in some cases, missing entirely. We would encourage firms to consider if their insider lists are accurately documented and suitably detailed. Requirements relating to insider lists, including their content, are set out in Article 18 of MAR.

It is important that firms consider the 'need to know principle' when determining which individuals need to be wall-crossed on a transaction and consequently included on an insider list. This principle helps firms and individuals in ensuring that inside information is only disclosed where it is in the 'normal exercise of an employment, a profession or duties'. Inside information disclosed otherwise constitutes unlawful disclosure and is prohibited by Article 10 and 14 of MAR. It is important to always keep the number of people privy to inside information to the minimum necessary to perform a particular role or task to the appropriate standard.

1 www.bankofengland.co.uk/markets/Documents/femrjun15.pdf
2 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0596&from=EN

Market abuse monitoring and surveillance

Post-trade monitoring and surveillance has a key role to play in both detecting and deterring market abuse. Article 16 of MAR includes requirements for firms to have effective arrangements, systems and procedures to detect and report suspicious orders and transactions.

We observed some examples during our review where firms periodically monitor the trading activity of market makers during periods when individuals at the firm had been wall-crossed. We consider this type of extra due diligence as an important step in mitigating the risks of market abuse and encourage all firms to consider performing this type of enhanced monitoring.

The sophistication of post-trade surveillance tools will vary according to a firm's size and activities. However, some firms in our review were unable to demonstrate how the market abuse surveillance tools they currently employ are effective and fit for purpose. Given the unique dynamics of the UK small & mid-cap equity market, which can include periods of very high volatility, both in terms of share price and trading volumes, firms need to be particularly careful when selecting suitable surveillance tools and setting alert parameters. In Market Watch 48 we gave some observations on the calibration of surveillance systems. We noted that the most effective surveillance programmes involved significant and careful calibration of both the alert parameters and alert logic based on the surveillance officers' experience of that firm's trading patterns and clients.

Ongoing work

We will continue to monitor the effectiveness of market abuse systems and controls at authorised firms as part of our risk based supervisory approach. Indeed, as we stated in Market Watch 50, we place as strong an emphasis on identifying weaknesses in regulated firms' controls as we do in pursuing market abuse. This work may include proactive (firm specific) deep dives and broader thematic studies of groups of firms or sectors.

Payment for order flow (PFOF) – Market-wide communication

Introduction

This article provides an update on payment for order flow (PFOF) following the publication of the FCA's Guidance on the practice in 2012[3] and our thematic review in 2014[4]. The intention of the article is to:

3 www.fsa.gov.uk/static/pubs/guidance/fg12-13.pdf
4 www.fca.org.uk/news/tr14-13-best-execution-and-payment-for-order-flow

- share the outcomes of our follow-up supervisory work following the publication of the thematic review findings in 2014
- reiterate our rules and clarify the regulatory obligations in relation to one area of residual non-compliance, namely conflicts management practices of firms in their dealings with eligible counterparty clients (ECPs), and
- signpost forthcoming regulatory changes under the revised Markets in Financial Instruments Directive (MiFID II)[5] to the best execution, inducements and conflicts of interest rules, with the latter further strengthening the framework for ECP business.

What is payment for order flow (PFOF)?

PFOF is the practice of an investment firm that executes client orders (typically a broker) receiving a fee/commission not only as an agent from the client originating the order but also from the counterparty with whom the trade is then executed (typically a market maker[6]).

We consider PFOF to be bad for our markets and a direct risk to all three of the FCA's operational objectives for the following reasons:

- It creates a conflict of interest between a firm (the broker) and its clients because the firm is incentivised to pursue payments from market makers rather than to provide best execution in the interests of their clients.
- It undermines the transparency and efficiency of the price formation process. This is because the prices paid by clients include hidden costs – and whilst clients may be aware of the level of commission they pay to their broker – they might not be aware of the higher spread that they may additionally need to pay to take account of the fees paid by the market marker.
- Forcing market makers to 'pay-to-play' can distort competition by creating barriers to entry and expansion. Indeed, if brokers refuse to look beyond fee-paying market makers, the most obvious way for new market makers to enter the market is to offer payment for order flow that is higher than the rates paid by existing market makers – an outcome that is inconsistent with promoting effective competition in the interests of consumers. Our supervisory work indicates that, for the most part, brokers routinely exclude non-paying market makers. This approach can result in poorer price outcomes for clients because, in addition to the wider spread that the client is likely to pay to account for the fees paid by the market maker, these 'non-paying' market makers might otherwise provide the most competitive pricing.

5 With which firms must comply from 3 January 2018.
6 For the definition of a market maker, please refer to the FCA Handbook: https://www.handbook.fca.org.uk/handbook/glossary/G696.html

Key supervisory findings

The key findings from our follow-up supervisory work are provided below:

- The large integrated investment banks have largely taken on board the clear messages from our policy and supervisory work and have ceased charging PFOF in respect of all client business and across all market segments.

- Independent brokers have mainly stopped charging PFOF in connection with professional client business in the market segments which have been the focus of our thematic and supervisory work. Residual non-compliance following TR14/13 has largely been dealt with through supervisory intervention.

- We have identified a number of independent brokers that continue routinely to charge market makers commission in return for order flow in respect of ECP initiated business. In this regard, our supervisory work has revealed that current practices purporting to manage the conflict of interest inherent in PFOF appear inadequate to satisfy the current SYSC 10 requirements. These practices would also not satisfy the enhanced expectations that we are proposing to introduce to implement MiFID II (see "the evolving landscape under MiFID II", below).

PFOF and ECP Business

As mentioned in TR14/13 and in our Guidance on the practice of Payment for Order Flow (FG12/13[7]), PFOF arrangements create an incentive for the firm (broker) to execute orders in a particular way and, therefore, a clear conflict of interest between the firm and its clients. These types of payment are incompatible with the rule on inducements[8] and also risk compromising compliance with our best execution[9] and conflicts of interest[10] rules. We would like to remind firms that whilst the best execution and inducements rules do not apply in their dealings with ECPs, they must comply with their obligations under SYSC 10 (conflicts of interest). The key issue for firms to consider is whether it is possible for a direct, self-created conflict such as PFOF to be adequately managed.

SYSC 10 requires firms both to identify and to manage conflicts of interest. This places the responsibility on the firm to maintain and operate effective organisational and administrative arrangements, taking all reasonable steps to prevent conflicts of interest from constituting or giving rise to a material risk of damage to the interests of its clients[11]. If these arrangements are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of a client will be prevented, the firm must clearly disclose the general nature and/or sources of conflicts of interest before undertaking

7 www.fca.org.uk/static/pubs/guidance/fg12-13.pdf
8 COBS 2.3.1R
9 COBS 11.2.1R
10 SYSC 10.1.3R, 10.1.4R, 10.1.7R, 10.1.8R, 10.1.9G, 10.1.10R
11 SYSC 10.1.7R

business[12]. Disclosure however, does not excuse the firm from its obligations to prevent the conflict of interest where this is possible, for example by ceasing to charge PFOF.

Throughout the course of our follow-up supervisory work of individual firms, we have yet to see a single example of an effective conflicts management arrangement for charging PFOF in the context of ECP-initiated trades. We have even found that some firms have no conflicts management procedures in place at all, which is a clear breach of the SYSC 10[13] requirements. Below we provide some worked examples of current market practices which are inconsistent with SYSC 10.

(a) Equalising payments amongst fee paying market makers

Several firms continue to use the argument that equalising the commission paid by market makers providing quotes is sufficient to mitigate the conflict of interest created by PFOF, since they are ostensibly not favouring one market maker over another based on the level of commission charged. This inadequately mitigates the conflict of interest and does not address the issue of hidden costs. There are still fees that the client is unaware of, and firms will continue to pursue payments from fee paying market makers rather than interact with non-paying market makers (who might provide better pricing). Indeed, evidence seen by the FCA suggests that where firms have included non-paying market makers on their panel, it is at best unclear whether or not the non-paying market making population receive any orders. Including these on a firm's panel when they are not actually used to execute orders strongly suggests that PFOF is still driving brokers' order-routing decisions.

Some brokers have further acknowledged that PFOF results in additional costs being passed on to their ECP clients, often times reflected in higher spreads charged by market makers (which agree to pay PFOF to attract order flow). In this situation, firms have an interest in the outcome of the transaction that is different from that of the client, and are making a financial gain at the expense of their clients which could clearly result in a 'material risk of damage to the interests of the client[14].'

12 SYSC 10.1.8R
13 SYSC 10.1.10R
14 SYSC 10.1.4R

(b) (Over) Reliance on disclosure

A number of firms rely solely on disclosure of these payments as a way of managing the conflict of interest to continue charging PFOF for ECP business. However, this approach is not consistent with the guidance set out at SYSC 10.1.9G which provides that, '[…] over-reliance on disclosure without adequate consideration as to how conflicts may be appropriately managed is not permitted'.

Although, in principle, disclosure can help to address the concern of PFOF creating hidden costs, many of these same firms are reliant on generic, high-level disclosures that provide no meaningful transparency to the underlying client or to the market. In practice, the actual disclosures made often fall short of the requirements on disclosure of conflicts in SYSC 10.1.8R. These require that the disclosure should include sufficient detail, taking into account the nature of the client, to enable them to make an informed decision about the service in the context of which the conflict relates. However, the types of disclosure that we have seen typically consist of a high-level reference to the possibility of commission being received within the firm's order execution policy. Often these fail to highlight either the existence or the amount of the payments, or the basic fact that the payments can create a conflict of interest.

More broadly, given that charging PFOF is a direct, self-created conflict of interest designed to benefit the broker, and which can easily be prevented (by simply ceasing to engage in the practice and charging a transparent brokerage commission inclusive of all costs), we view disclosure in this context as an inadequate conflicts management tool. The FCA's Guidance on PFOF makes very clear that disclosure should be considered as a measure of last resort only[15].

Finally, we are also aware that some firms have re-categorised their clients from professional client to ECP status with a view to circumventing the application of certain conduct of business rules (e.g. the obligation to provide best execution). Whilst there are other circumstances in which re-categorisation is perfectly legitimate (e.g. upon request of the client), we would remind firms to ensure that such decisions are compliant with the FCA's client categorisation rules (COBS 3).

Overall, the evidence that we have seen so far tends to suggest that there may be no effective way of managing a self-created conflict of this nature.

The evolving landscape under MiFID II

In anticipation of 3 January 2018[16], firms should be considering the regulatory changes forthcoming under MiFID II, which will place further restrictions on

15 SYSC 10.1.9G

16 Following the result of the United Kingdom's referendum on its membership of the European Union (EU), the FCA published a statement on 24 June in which we said: 'Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect'. See: https://www.fca.org.uk/news/european-union-referendum-result-statement

charging PFOF. For professional client business, MiFID II further reinforces the ineligibility of these third-party payments when executing orders on behalf of clients, providing that 'an investment firm shall not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular trading venue or execution venue which would infringe the requirements on conflicts of interest or inducements […]'[17].

MiFID II will also extend a number of general principles to the provision of investment services to ECPs, in particular the obligation on firms to act honestly, fairly and professionally and communicate in a way that is fair, clear and not misleading[18]. Moreover, it makes a number of enhancements to the conflicts of interest requirements[19] which will be particularly significant for firms providing investment services to ECPs (although these are equally relevant to professional and retail client business). Firstly, coupled with the existing requirement to manage conflicts of interest, MiFID II gives explicit and even clearer emphasis to the need to prevent conflicts from arising in the first place. In doing so, firms will need to take all appropriate, rather than only reasonable, steps to identify and to prevent or manage conflicts of interest. In this context, when dealing with a direct, self-created conflict of interest which characterises PFOF arrangements, the most straightforward method of complying with the updated rules (as is the case today in respect of the current rules), would be to prevent the conflict from arising in the first place – that is, by not entering into such arrangements at all[20]. This approach is supported by the fact that, as highlighted above, we have yet to see throughout the course of our interactions with firms to date, a single, effective method of managing the conflict created by PFOF.

Finally, MiFID II also tightens the rules around the use of disclosure in the management of conflicts of interest[21], making explicitly clear that disclosure can only be used as a method of last resort, when the firm's administrative and organisational arrangements to manage the conflict of interest have failed. Indeed, in these circumstances, the content of the disclosure to be made will need to be specific to include descriptions of the conflict(s) of interest that arise, the steps undertaken to mitigate the risks attached, and the risks to the client.

The cumulative impact of these changes, which further raises the bar for compliance, means that firms will not be able to charge PFOF without breaching the new standards that we are proposing to introduce to implement MiFID II.

17 Article 27(2) MiFID II
18 See chapter 10 of our December 2015 Consultation Paper: https://www.fca.org.uk/static/documents/consultation-papers/cp15-43.pdf
19 See pages 25-28 of the FCA's recent Consultation Paper: https://www.fca.org.uk/static/documents/consultation-papers/cp16-19.pdf
20 It will be a commercial decision for the firm (broker) as to how it accounts for any loss of revenue from ceasing to charge PFOF. For example, a firm may choose to either increase its transparent brokerage fees to the client, or absorb some or all of the lost revenue itself
21 MiFID II elevates the requirement that disclosure should be a method of last resort from the status of a recital to an operative article