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Financial Services

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The FCA's Heightened Expectations Around Insider Dealing and Market Manipulation Systems and Controls (GC 18/1) – Some Practical Guidance

Firms should consider the implications for their existing anti-market abuse controls and should consider responding to the consultation either directly or through a relevant industry body.

On 5 April 2018, we reported in an initial alert that the UK Financial Conduct Authority (FCA) is consulting upon updating its Financial Crime Guide (FCG), including adding a new chapter 8 on insider dealing and market manipulation. This is the first time that the FCA has sought to address market misconduct crimes through the FCG.

In the UK we have parallel civil law prohibiting market abuse (derived through the direct effect of the EU Market Abuse Regulation ("MAR") – EU596/2014) and criminal laws prohibiting insider dealing and market manipulation/misleading statements (Section 52 Criminal Justice Act 1993; Sections 89-91 Financial Services and Markets Act 2012).

In the consultation document, the FCA highlights what it suggests is a key distinction between a firm's obligations under Article 16(2) of MAR and the financial crime systems and controls requirements set out in Senior Management Arrangements, Systems and Controls ("SYSC") 6.1.1R: namely:

- Article 16(2) of MAR requires persons professional arranging or executing transactions to **detect and report** potential (civil) market abuse (which is different from the obligation on market operators and firms operating trading venues where Article 16(1) of MAR imposes a **prevent** obligation); whereas
- SYSC 6.1.1R requires firms to take steps to **counter** the risk of the firm or its products/services being used for the purposes of financial crime.

The definition of "financial crime" for the purpose of the rule in SYSC 6.1.1 R is "*any kind of criminal conduct relating to money or to financial services markets including any offence involving fraud or dishonesty, handling the proceeds of crime or the financing of terrorism*". Notwithstanding this wide definition, the only reference to a specific type of financial crime in SYSC is "money laundering risk" (in respect of which SYSC contains additional guidance on expected controls) with cross references in SYSC to the FCG. The FCG has long included material on money laundering and terrorist financing, fraud, bribery and corruption, sanctions and asset freezes and (more recently) data security but in the version currently applying to firms refers the reader to Chapter 1 of the separate Market Conduct sourcebook for all matters of market misconduct.

The FCA makes clear that the guidance in the draft chapter is intended to address *criminal* insider dealing and market manipulation and states that "*This document does not provide any FCA guidance in relation to MAR article 16*." The FCA notes that it cannot and will not mandate that this guidance applies to those instruments that are captured by MAR but not by the criminal regimes. Nevertheless the FCA is clearly expecting that firms will voluntarily apply the guidance in the draft chapter to all financial instruments that are covered by both the criminal and civil regimes. Paragraph 8.1.5 of the draft chapter states "*We recognize that many firms will not distinguish between the criminal or civil regimes for the purposes of conducting surveillance and monitoring of their clients' and employees' activities. As such firms may find it simpler to consider this guidance as applying to all instruments to which both MAR and the criminal regimes….apply*".

WHAT DOES THE FCA MEAN BY "COUNTER"?

It is critical for firms covered by MAR article 16(2) to understand whether the FCA is expecting, though its new proposed guidance in the FCG, that something new or additional will be done by firms over and above the controls (in particular post trade surveillance) that have been put in place by firms to satisfy the requirements under MAR. The FCA's precise expectations in this regard are not clear from wording of the draft chapter. It could be onerous for firms if the FCA is seeking by this means to extend to all firms a higher "prevent" standard, akin to that which applies under Article 16 (1) of MAR to market operators and firms that operate a trading venue.

In normal usage, the word "counter" means to act in opposition to, or otherwise resist or defend against, some event or behavior. It does not necessarily equate to successful "prevention" of all instances of the event or behavior. However, the FCG does make a number of references to "prevention". For example, paragraph 8.1.9(1) of the proposed new chapter states that "*appropriate measures for the* ***prevention*** *of financial crime are likely to fall into two distinct categories (1) the identification and prevention of attempted financial crime* ***pre-trade****, and (2) the mitigation of future risks posed by clients who have been identified as having traded suspiciously*". In a similar vein, the guidance on policies and procedures at paragraph 8.2.3 of the draft chapter states firms should ensure that their policies and procedures cover both identifying and preventing attempted financial crime **before any trade is executed** and mitigating future risks posed by clients who have already been identified as having traded suspiciously

WHAT THE GUIDANCE MEANS IN PRACTICE

It is not clear whether the FCA is expecting an additional level of pre trade checks above those that are customary for firms complying with MAR 16 (2) and it may be hard to see what more could be done that is proportionate or effective in that respect. What is clear is that when suspicions of market abuse arise a firm's obligations do not end with filing a Suspicious Transaction and Order Report under MAR. At the same time firms need to consider whether the behaviour may potentially also constitute a criminal offence of insider dealing or market manipulation. If it may and has generated proceeds of crime then a Suspicious Activity Report to the NCA will also be required. Further, having identified suspicious behaviour, according to the draft guidance the firm will then be expected to consider how to mitigate risks of further inappropriate behaviour by the client such as carrying out enhanced due diligence and enhanced monitoring of the client's trading activity (including applying enhanced scrutiny to incoming orders prior to execution), setting specific

pre-trade limits, restricting access to particular markets or instruments, restricting services like Direct Market Access, and ultimately declining client business or terminating client relationships if appropriate.

The draft chapter sets out various expectations and examples of good and poor practice (as summarized in our initial alert). However, different types of firms face different risks and will want to design controls that are suitable for their particular circumstances, as well as being proportionate and effective.

We would be delighted to discuss any particular concerns you might have on this subject and/or your proposed response to the FCA's consultation. Please do get in touch if we can be of any assistance.

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