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TR 15/1 REVIEW ON ASSET MANAGEMENT FIRMS AND THE RISK OF MARKET ABUSE

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On 18 February 2015, the FCA published its thematic review on asset management firms and the risk of market abuse (TR15/1).

The paper presents the regulator's findings from the thematic review of how asset management firms control the risk of committing market abuse. The review considers how firms control the risks of insider dealing, improper disclosure and market manipulation, with a primary focus on equities and insider dealing.

Market abuse causes integral damages to the financial markets and undermines confidence in the financial services system. Association with market abuse can cause reputational damage to firms and can lead to substantial financial loss. The FCA's regime requires all regulated firms to have effective processes for identifying, monitoring and managing the risks of market abuse.

The review covered 19 asset management firms of various sizes (AUMs ranging from £200m to over £100bn) including long-only asset managers, hedge fund managers and an occupational pension scheme. The overall finding of the review was that firms need to pay more attention to the possibility of receiving inside information through all aspects of the investment process.

Below we have provided a glance card with the key findings of the TR15/1 review along with good and bad practice examples taken from the firms that participated in the review.

Key points	Poor practices	Good practices

MANAGING THE RISK THAT INSIDE INFORMATION COULD BE RECEIVED BUT NOT IDENTIFIED (WALL CROSSINGS)

Key points

- Firms need to have effective policies to identify and capture inside information that is intentionally received through wall crossing by investment banks.
- Firms need to have effective policies for when inside information is unintentionally received from a conversation about a proposed wall crossing (a "Sounding") when that wall crossing is not taken up.
- Firms should require fund managers to confirm whether inside information has been received following a Sounding.

Poor practices

Example: *A fund manager is told the name of a company that is planning a corporate action during a Sounding but takes no further information. The fund manager recognises this is potentially inside information and decides not to trade any of the company's shares. However, the company is not added to the restricted list and the compliance function is unaware of this situation. This creates the risk of another fund manager trading while inside information is held in the firm.*

Good practices

Examples: *Five firms had an initial point of contact for Soundings that was independent of the fund managers. In some cases this enabled Soundings to be rejected without sharing any information with fund managers; for example, when the subject of the wall crossing was in a geographical area that was outside a fund manager's mandate. In other cases, where the fund manager was consulted and decided not to take up a wall crossing, there was an independent assessment of any information received to verify that it did not constitute inside information.*

A firm required fund managers to make a documented assessment of whether inside information had been received following any declined Soundings. This reduced the risk that the receipt of inside information could go undetected.

MANAGING THE RISK THAT INSIDE INFORMATION COULD BE RECEIVED BUT NOT IDENTIFIED (COMPANY-SPECIFIC RESEARCH)

- Firms need to have practices to avoid the unnecessary receipt of inside information when conducting company-specific research. These practices need to be formal and applied consistently.
- Firms should encourage staff to discuss any concerns about whether inside information might have been received with a designated point of contact and consider whether the nature and volume of such discussions is appropriate given their investment activities.
- Firms should consider the benefit relative to the risk of attending meetings where there is a significant possibility that inside information might be inadvertently received (for example, meeting with a consultant who is likely to possess inside information). Where firms choose to attend such meetings, they must consider additional practices to promote the identification of any inside information that could be received.

Examples: *At one firm that did not have a consistent approach to meeting companies during close periods, fund managers had met with the management of a large listed company less than a week before it published results.*

In one firm, the compliance function was unaware that an investment team was using an alpha capture system (this enabled sell-side firms to submit trading ideas electronically through a dummy portfolio and to be allocated commission based on the returns of the dummy portfolio). The potential market abuse risks had not been appropriately considered and the firm had no checks or controls around this system; for example, to confirm it was not receiving input from sell-side firms front running analyst recommendation changes.

Fund managers viewed it as the responsibility of the management of listed companies, investment banks and other research providers to assess whether any information provided could be inside information.

Examples: *Fund managers at one firm reduced the risk of receiving inside information from investee companies by avoiding any meetings with them during close periods (a period of time before a company publishes results) other than in exceptional circumstances and following pre-clearance from compliance.*

One firm prevented fund managers from meeting with consultants who had recently worked for a listed company because of the possibility they could be in possession of inside information. Another firm required consultants to confirm they would not disclose inside information before meeting with a fund manager.

One of the larger firms used a 'material non-public information hotline' to encourage vigilance about whether inside information could have been received in the research process.

In a smaller firm, the most senior fund manager regularly asked more junior staff about the content of meetings and whether there was any concern that inside information could have been received.

CONTROLLING ACCESS TO INSIDE INFORMATION AND MANAGING THE RISK OF IMPROPER DISCLOSURE

- Firms should use restricted lists to document receipt of inside information.
- Firms should have policies for the sharing of inside information on a “need to know” basis.
- Firms should consider how they can reduce these risks, which may include keeping documentation of who knows what inside information, particularly in sensitive cases.

Examples: *One firm notified all traders when inside information had been received as an interim control to prevent trading until a system block was in place (we consider system blocks and pre-trade controls in more detail below). In addition to being notified of the company name, the traders also received the detail of the inside information.*

Examples: *One firm kept a detailed log of who knew inside information. Knowledge of the information was not shared beyond the person wall-crossed, other team members who needed the information to fulfil professional responsibilities (e.g. a fund manager who might participate in a proposed placing), and compliance. Senior management and traders were unaware of the information or the restriction, unless they attempted to trade the stock.*

PRE-TRADE CONTROLS TO PREVENT MARKET MANIPULATION

- Firms need to have segregated equity dealing functions.

Examples: *One firm with a large number of employees had no independent check prior to an order being placed. In another firm there was a segregated, independent, equity dealing function for all except one of the fund management teams. The exception was established because the fund manager thought trading would be improved by having a dealer within his team. No other compensating controls were put in place and this reduced the effectiveness of market abuse controls.*

Examples: *In one firm, management considered the volume of trades to be too small to merit a segregated equity dealing function, but required all fund managers’ orders to be signed off by an independent colleague. This provided an opportunity to review any concerns prior to execution.*

PRE-TRADE CONTROLS TO PREVENT INSIDER DEALING

- Firms should use system-based pre-trade controls to prevent trading in the financial securities of companies that had been restricted due to the possession of inside information.
- Firms should use a warning prompt that has to be overridden to trade a restricted stock, combined with a post-trade check to highlight if this has occurred.
- Firms should record the fixed telephone lines of staff directly involved in the investment process with a minority also recording mobile phones.
- Firms should ensure they have effective controls to prevent trading when it is known that a portfolio manager has access to inside information about the security to be traded.

Examples: *One firm did not implement system-based trade restrictions on a timely basis following the receipt of inside information: this took several hours in some cases. To prevent trading in the relevant security prior to the system being updated, the firm notified all dealers when inside information had been received and instructed that trading should be barred. This firm had the capability to use system-based pre-trade controls so the reliance on manual intervention was unnecessary and increased the risk of market abuse due to human error.*

Examples: *In some firms, the trading function was situated in a segregated, secure area. Where a fund manager has placed a large trade relative to the volume of the security being traded, knowledge of this trade could be inside information for other fund managers; a physically segregated dealing function reduces the risk of other fund managers coming into contact with this information.*

POST-TRADE SURVEILANCE

Post-trade surveillance has a key role to play in both detecting and deterring market abuse:

- Firms should have post-trade surveillance programmes that are effective in identifying

Examples: *One firm used the same percentage price change in all markets when identifying trades to follow up on. In more volatile emerging markets, this approach highlighted an unmanageable number of irrelevant trades, making trades genuinely worthy of*

Examples: *One firm visited used statistical analysis to identify post-trade price movements outside a set probability range to trigger surveillance follow up. This price-move trigger was varied by market according to that market's* market abuse.

investigation harder to spot.

Another firm had no documentation of the research process and could not verify the trade rationale or what information had been used to inform the trading. This made it difficult to independently assess any trades highlighted by post-trade surveillance.

volatility.

Post-trade surveillance at one firm highlighted a pattern of successful trading by a fund manager prior to non- routine company announcements. This was investigated thoroughly, including reviewing all communications and an interview with the fund manager. There was no evidence that any inside information had been received but this trading pattern differed from the core long-term investment strategy and management felt it increased the risk of market abuse. This was communicated to the fund manager who reverted to the core investment strategy.

One firm conducted regular monitoring of the recorded telephone lines of fund managers and traders, listening to a sample of conversations. Monitoring lines will not be practical for all firms, but it increases the likelihood of detecting market abuse as well as incentivising staff to escalate any concerns that inside information might have been received.

PERSONAL ACCOUNT POLICIES

FCA rules require firms to have a PA dealing policy. This offers protection to the firm and to individuals and is particularly relevant when trading is being undertaken externally and is not caught by other controls within the firm.

Examples: *Three firms did not effectively manage the risk of a fund manager trading ahead of a fund. Two of these firms had no requirement about what time would be required between a PA trade and a fund trade. Another firm only required that fund managers did not PA trade within one hour of a fund trade. This was unlikely to be sufficient to prevent*

Examples: *All except one firm required pre-trade approval for PA dealing and, in the majority of firms, there was a post-trade review to monitor for any suspicious activity.*

- Firms should consider their PA dealing policies and ensure that the requirements under COBS 11.7 are met, including adequate arrangements aimed at preventing market abuse.

market abuse through front running, given the firm had many holdings in less liquid equities and had the capacity to influence these share prices through its trading activities.

TRAINING

- Firms should consider the frequency and quality of training on market abuse and, where appropriate, make improvements to ensure staff knowledge is sufficiently current for the firm to effectively identify, manage and monitor the risk of market abuse.
- Where there is a reliance on online training, it should be effective.

Examples: *At one firm, which relied solely on online training for market abuse, the training log showed a number of staff had completed the market abuse module in less than half the stipulated time. There had been no follow up to understand why this was the case or whether the staff had understood the material. Where staff do not have an up-to-date understanding of market abuse issues, related risks are significantly increased.*

Examples: *Approximately half the firms had face-to- face training to complement on-line training. This encouraged debate of real-life scenarios and a full understanding of how market abuse rules apply in practice. Three firms used examples in training from their own experiences of fund managers and analysts inadvertently receiving inside information, to promote awareness of this risk.*

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