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MAD II / MAR

Introduction

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Stéphane R. Blais is a Director in Deloitte's FS Risk Advisory Practice. Prior to joining the firm, Stéphane spent 10 years as a financial regulator, at the FSA/FCA. There he assessed Market Abuse and Front Office Controls in Commodities Trading Firms, the results of which are published in the FCA's Market Watch 49. Stéphane contributed to the development of the FCA's Wholesale Conduct Strategy and provided technical input to Thematic Advisory Groups (TAGs).

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Simon is a Manager in Deloitte's FS Risk Advisory team and specialises in assisting wholesale firms with the management of conduct of business and compliance risks, with a particular focus on market abuse. Simon has worked with a number of firms to develop their market abuse risk and control frameworks and is currently assisting a number of firms with their MAR implementation programmes.

Agenda

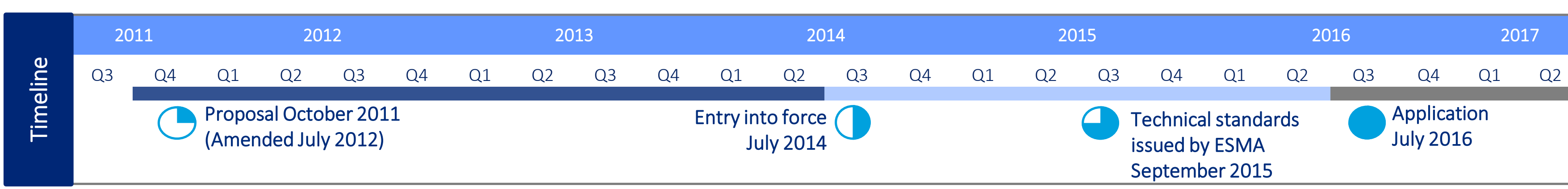
1. Background to MAR
2. Key Developments and Challenges
3. Enforcement Case Studies
4. Market Abuse Control Frameworks

1. Background to MAR

Background to MAR
Purpose & timeline

MAR will replace the existing Market Abuse Directive and related FCA rules. The new regime establishes a common regulatory framework on insider dealing, market manipulation and measures to prevent market abuse.

- Ensure that regulation keeps pace with market developments
- Strengthening the fight against market abuse across commodity markets
- Reinforcing the investigative and administrative sanctioning powers of regulators
- Harmonising certain key elements e.g. reporting and notification requirements



Overview
MAD I vs. MAR

MAR significantly increases the scope of the existing market abuse regime

	MAD I	MAR
Financial instruments admitted to trading on a regulated market	●	●
Financial instruments admitted to trading on a Multilateral Trading Facility (MTF)		●
Financial instruments admitted to trading on an Organised Trading Facility (OTF)		●
Financial instruments, the price of which depends on the price of the instruments referred to above inc. CDS and CfDs.		●
Behaviour or transactions, including bids, relating to auction markets for emissions allowances		●
Behaviour in relation to benchmarks		●
Spot commodity contracts excluding wholesale energy products		●
Financial instruments relating to the transfer of credit risk		●

● In-scope instruments

● Instruments that are only in-scope for the market manipulation prohibition

Overview
Key Changes

Inside Information & Insider Dealing
Extended scope under MAR including information relating to spot commodity contracts and cancelling or amending an order.

Suspicious Transaction & Order Reporting
MAR extends the existing obligation to report suspicious transactions to include suspicious orders.

Market Manipulation
The market manipulation offence has been extended to include attempted manipulation and behaviour in relation to benchmarks.

Insider Lists & Market Soundings
More detailed rules on insider lists and a new framework on market soundings to gauge investors' interest in possible transactions.

Investment Recommendations
MAR strengthens the regime that requires persons producing investment recommendations to ensure that information is objectively presented and to disclose potential conflicts.

Manager's Transactions
Persons discharging managerial responsibilities within issuers must notify the issuer and regulator of relevant personal transactions they undertake.

2. Key Trends & Challenges

Key Developments & Challenges

Market manipulation & STORs

Key Developments

Market Manipulation

- Transmitting false or misleading information or providing false or misleading inputs in relation to a **benchmark**.
- **Spot commodity contracts** and auctioned products based on **emission allowances**.
- Prohibition on misleading investors on the basis of **opening as well as closing prices** (MAD referred to only in closing prices).
- Prohibition on **placing or amending orders** on a trading venue (i) disrupt or delay the functioning of the trading system; (ii) make it more difficult for other persons to identify genuine orders; or (iii) create false or misleading signals by entering orders to initiate or exacerbate a trend.

STORs

- Firms are required to report both **suspicious transactions and suspicious orders** to the competent authority without delay.
- Firms are required to establish **surveillance systems as well as internal procedures** to facilitate detection and reporting.

Challenges

- Re-calibrating surveillance systems to reflect the increased scope
- Prioritising monitoring activities using a risk-based approach
- Capturing and monitoring orders, particularly voice orders
- The trade-off between automated monitoring systems and human analysis
- Developing pre-trade controls to identify suspicious orders
- The broad definition of what constitutes a benchmark
- The efficiency of processes for making STORs

Key Developments & Challenges

Insider Trading & Market Soundings

Key Developments

Insider Trading

- The insider dealing offence has been extended to include **cancelling or amending orders** based on inside information.
- The prohibition against recommending that another individual trade on the basis of inside information has been extended to include **inducing individuals** to cancel/amend orders based on inside information.
- **Insider lists** must be in a prescribed format, be maintained for 5 years and firms must make them available to regulators as soon as possible upon request.

Market Soundings

- **Disclosing participants** will be required to meet several conditions before disclosing inside information:
  - Assessing whether inside information will be disclosed;
  - Informing the recipient of their obligations;
  - Obtaining consent from the recipient to receive the information; and
  - Maintaining written records both before and after the disclosure.
- The **receiving participant** must assess for itself whether it is in possession of inside information and when it ceases to possess inside information.

Challenges

- Update Compliance monitoring processes to reflect the increased scope
- Rolling out training to educate individuals about the new offences
- Updating market sounding procedures
- Determine an approach for dealing with HR information within the insider list
- Review existing information barriers to ensure they prevent unlawful dissemination
- Ensure that individuals receiving market soundings are captured on the insiders list

Key Developments & Challenges

Insider Trading & Market Soundings

Key Developments

Investment Recommendations

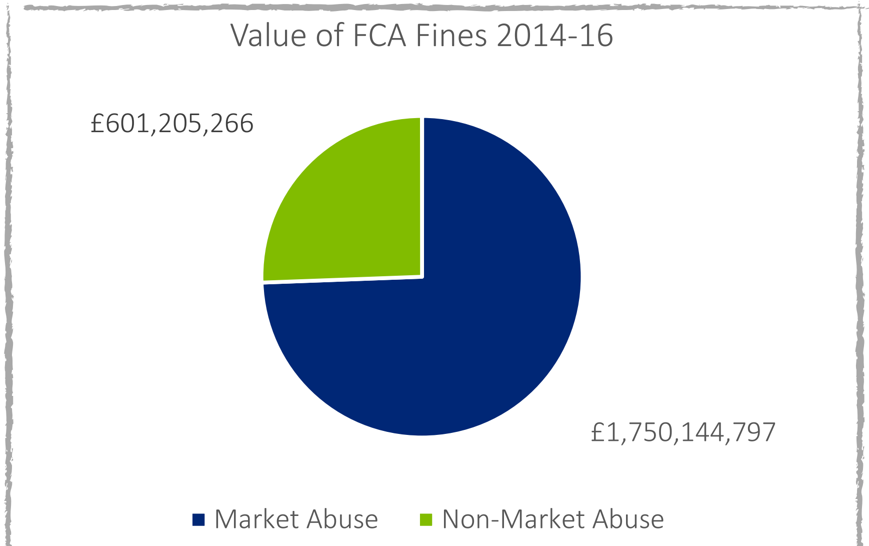
- Captures any information which **suggests or recommends and investment strategy** concerning a financial instrument.
- MAR **extends the scope** beyond individuals who are producing recommendations as part of their day-to-day business to include anyone producing or disseminating a recommendation.
- Information must be **objectively presented** and firms must **disclose any conflicts of interest** concerning the financial instrument to which the recommendation relates.
- Firms will be required **to record all investment recommendations made** at the issuer and security level and make 12 months of this data available when making new recommendations

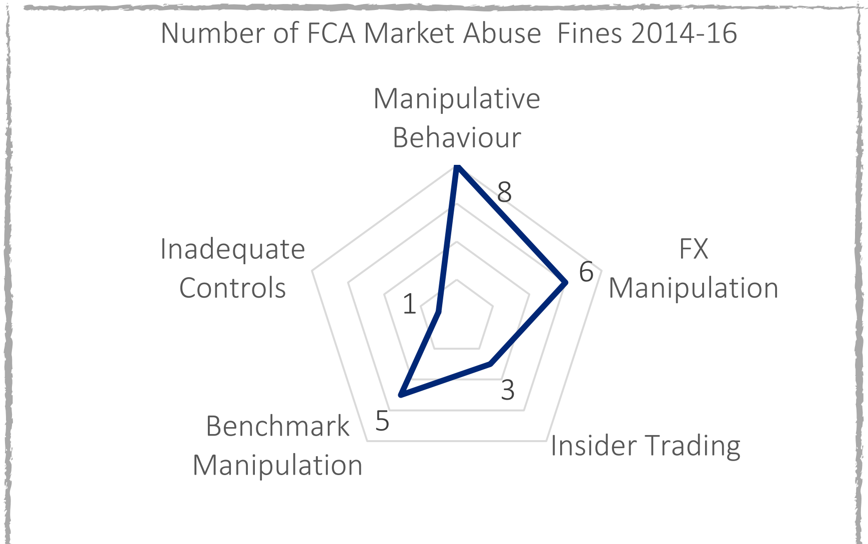
Challenges

- IT investment is necessary to record and maintain recommendation histories
- Changes to business processes required to record information
- Identifying individuals who make recommendations
- Despite the increased scope, rules have been written in the context of traditional research recommendations
- Ability to disclose conflicts of interest is dependent on having effective identification processes

3. FCA Enforcement Action

FCA Enforcement Action
Fines





Key Trends

- Recent enforcement action has been focussed on industry-wide issues (LIBOR and FX manipulation).
- The number of market abuse enforcement cases is relatively low in comparison to the FCA's overall number of fines although the values account for the vast majority of fines.
- The average value of fines against individuals is falling – 21% decrease between 2014 and 2105.
- The FCA is focussing on the effectiveness of firm's control frameworks as well specific cases of market abuse – this is likely to continue post MAR implementation.

FCA Enforcement Action
Case study

Case Study

Firm: WH Ireland

Penalty: £1,200,00 fine and restriction on taking on new clients

Key Findings:

The FCA found that WH Ireland failed to take reasonable care to have effective systems and controls to protect against the risk of market abuse. In particular the FCA identified the following issues:

- Weak controls to mitigate the risk of market abuse from inside information, personal account dealing and conflicts of interest;
- Deficient Compliance oversight including monitoring of controls, provision of MI, risk assessment and dealing with suspicious transactions;
- Poor governance including a lack of market abuse MI in Board packs; and
- A lack of a formal process for identifying and recording training that had been given.

Lessons Learned

1. Market abuse risks should be owned by the front office and the business should also operate some controls. However, Compliance still has a key role to play through its own controls and regular *"check the checker"* monitoring.

2. Board level oversight of market abuse risks is essential although this will only be effective with suitable MI

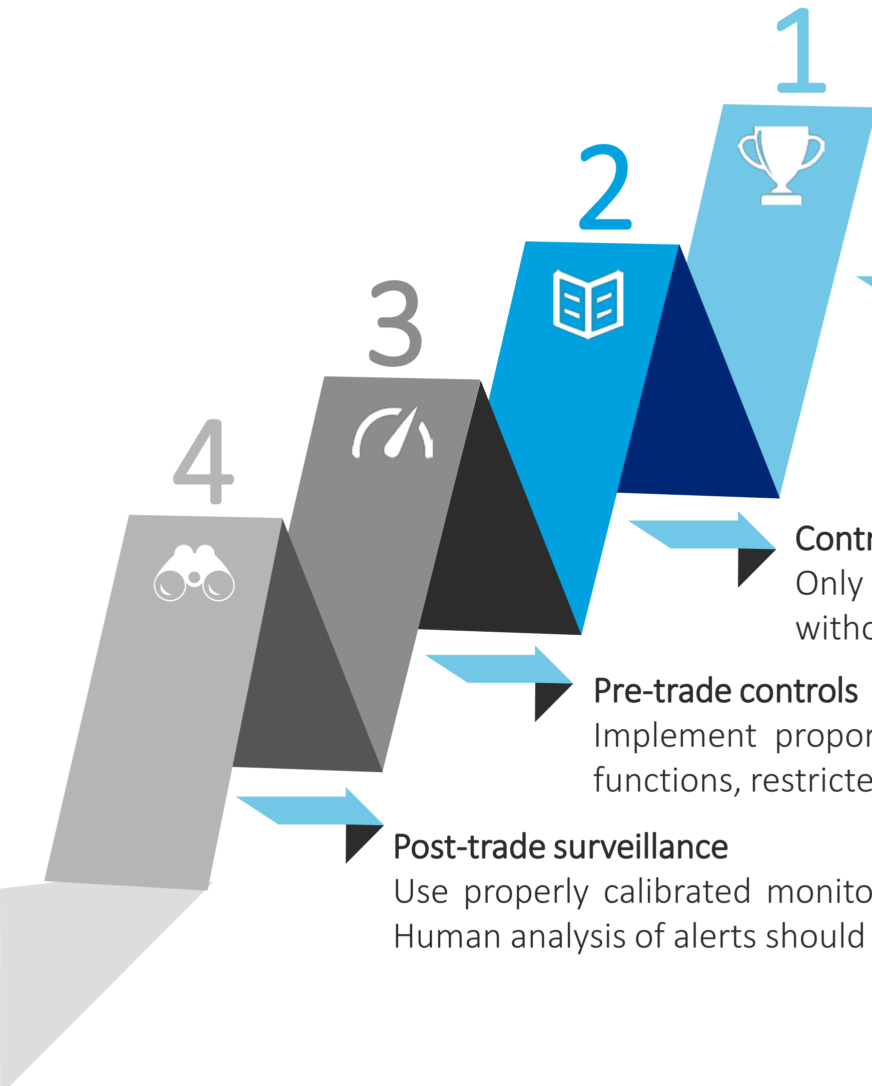
3. The FCA is increasingly focused on the adequacy of control frameworks. As the rules under MAR become more prescriptive this is likely to continue.

4. Evidencing action taken (e.g. training) is key– if it isn't documented then it didn't happen

4. Market Abuse Control Frameworks

Market Abuse Control Frameworks

Developing an effective market abuse control framework



Training and awareness

Conduct periodic industry-specific training, using real-life examples, to ensure understanding of rules is up-to date.

Control access to inside information

Only disclose stock restrictions to individuals who need to know and without disclosing specific information relating to the restriction.

Pre-trade controls

Implement proportionate pre-trade controls for example segregated dealing functions, restricted stock blocks and independent review of orders.

Post-trade surveillance

Use properly calibrated monitoring of trading patterns to identify potential areas of abuse. Human analysis of alerts should record sufficient information to maintain STOR records.

Market Abuse Control Frameworks
Framework Elements

A firm's market abuse monitoring framework should incorporate a number of different types of monitoring, each with different objectives, approaches and outputs. These different types of monitoring should be conducted in unison to provide the firm with a holistic view of how effective its approach to managing its market abuse risks is. The diagram below sets out the four elements that comprise a holistic monitoring framework.

Market Abuse Monitoring			
Periodic Testing	Thematic Reviews	Risk Response Reviews	Trade, Comms & Employee Surveillance
▪ Periodic monitoring consists of routine checks/analysis of key controls or control processes. This covers both periodic monitoring of 1^{st} line controls and independent checking of 2^{nd} line controls.	▪ Thematic reviews consist of scheduled, risk-based reviews which assess the overall effectiveness of the front-to-back control framework (including both design and operating effectiveness) for a particular risk or desk.	▪ Risk response reviews consist of tailored reviews which are initiated at short notice in response to internal or external events which may cause a market abuse risk to crystallise or which may lead to the emergence of a new market conduct risk.	▪ Trade, communications and employee surveillance is conducted using an automated solution which identifies instances of potential market abuse, reviews emails and chats for specific key phrases and identifies changes in the patterns of employee behaviour such as working hours.

Risk-based Approach to Monitoring

In order to ensure efficient use of time and resources, Compliance should adopt a risk-based approach to determining the frequency of monitoring activities. A market conduct risk assessment should be completed and the level of monitoring focus for each risk be determined by the rating for that risk, with higher rated risks being subject to more intensive monitoring.

The following drivers should be used to define the Market Abuse Monitoring Plan and to identify the need for risk response reviews: management input, risk assessment outputs, internal and external events, regulatory focus, regulatory change and previous monitoring activities.

Market Abuse Control Frameworks

Mitigating Risk Across the 3 Lines of Defence

	First Line of Defence		Second Line of Defence	Third Line of Defence
	Supervisory Oversight	COO / FO Risk	Compliance	Internal Audit
PREVENTATIVE MEASURES	Risk Identification Training Information Barrier Ownership Pre-trade Controls Pre-sounding Procedures Effective Oversight & Supervision		Risk Identification Oversight Training Information Barrier Review Transaction Review & Approval	Independent Framework Assessment
DETECTIVE MEASURES		Post-trade Monitoring Communications Monitoring	Post-Trade Monitoring Communications Monitoring Thematic Reviews	Independent Framework Assessment

Q&A

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