FINANCIAL CONDUCT AUTHORITY

Market Watch

Newsletter on market conduct and transaction reporting issues

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Contents

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We have reviewed industry implementation of the Market Abuse Regulation (MAR). In this edition of Market Watch, we outline our findings and offer clarity on some of the issues raised. We also consider 'manufactured credit events' in the credit default swap (CDS) market.

Market abuse – your role in protecting the market

Confidence in the integrity of markets is a key foundation of markets working well. Assurance that the market is clean, orderly and transparent helps issuers access finance and the buy-side to fulfil their investment mandates. Market abuse erodes this trust. It increases the costs of trading and distorts the playing field, undermining fair competition and reducing confidence in UK securities.

We all have an interest in ensuring the UK remains an attractive place to do business. As a market participant, you are the first line of defence. We expect market participants to remain vigilant and to be proactive in preventing and responding to market abuse.

Compliance with MAR

Complying with MAR is more than adhering to a set of prescriptive requirements. Julia Hoggett, Director of Market Oversight at the FCA, described compliance as 'a state of mind' in a November 2017 speech. We encourage market participants to familiarise themselves with the key messages in this speech.

The most effective compliance we saw during our review was

where participants could demonstrate that their risk assessments were calibrated to the markets and asset classes they operate in. As we highlighted in Market Watch 56, participants should be able to demonstrate that their approach is responsive to changes to their business, market practice and the regulatory environment. This may include developments in automated trading, encryption technologies, artificial intelligence and social media.

Effective compliance with MAR requires strong judgment. Market participants should be confident that their systems can detect and respond to abusive behaviours. The list of manipulative behaviour indicators has been updated in MAR, however, this list is neither exhaustive nor determinative. Abusive behaviour has many guises, and participants should remain vigilant for new forms. Market participants must exercise their own judgment when assessing potentially manipulative behaviours. They must take account of the characteristics of the financial instruments and markets they are operating in. In this assessment, firms should ensure they have properly considered their regulatory obligation to counter the risk of financial crime.

Our review – what we found

Our review included meetings with firms, surveys sent to issuers of financial instruments and asset management firms and analysis of our own data. We considered the application of MAR broadly, with a particular focus on the implementation of the market soundings regime and insider lists.

We found that many market participants have a good understanding of their obligations under MAR and have configured their systems and controls accordingly. However, there remain areas where firms are struggling to comply. This includes surveillance of all orders and transactions.

When MAR came into force, firms told us that quote surveillance would require an additional technology build, and we recognised that this might take time to design and implement. However, 2 years into the regime, we now expect firms to be fully compliant with the obligation to undertake quote surveillance.

Reminder about suspicious transaction and order reports (STORs)

We would like to remind market participants that any person professionally arranging or executing transactions must establish and maintain effective arrangements, systems and procedures for detecting and reporting suspicious orders and transactions. As we reminded firms in Market Watch 56, this is a multi-asset exercise. Currently, well over 70% of the STORs we receive are related to insider dealing in equities. However, we expect firms to perform surveillance across all relevant asset classes, including fixed income and commodities. Firms should refer to Market Watches 48, 50 and 56, which provide further detail on effective compliance.

Market soundings

Market soundings can play an important role in the smooth functioning of financial markets. While sounding the market won't be appropriate ahead of every transaction, it can be a useful tool for issuers and can assist price discovery. It can also be of use to those being sounded, as it provides early notice of a transaction and the ability to influence its structure and price.

MAR formalises a regime for conducting market soundings. This applies where the financial instruments subject to the potential transaction fall within the scope of MAR.

The intent of the market soundings regime is to protect against any allegation of unlawful disclosure of inside information where the market soundings regime is correctly followed. It is intended to help rather than hinder issuers, intermediaries and investors in gauging interest ahead of new issues. During our review, we did not observe any impact on the ability of issuers to raise capital on UK markets following the introduction of the market soundings regime. We were encouraged that many firms were using the protection offered by the market soundings regime. Seventy-six percent of issuers who responded to our survey said their appetite for initiating soundings had either remained constant or increased following MAR coming into force. Of the asset management firms that responded to a separate survey, 87% reported that their interest in receiving soundings had remained the same or increased over the same period.

How investors receive market soundings

Investors have adopted different models for receiving market soundings, with some choosing to appoint 'gatekeepers' in compliance or front-office teams as a first point of contact. These gatekeepers will decide whether to accept a wall-crossing and how it will operate in practice. Investors should retain the flexibility to determine the internal organisation that best suits their business model. However, as set out in Market Watch 51, we recognise the benefits of a gatekeeper model in ensuring a consistent approach and minimising opportunities for information leakage. On appointment of a gatekeeper, communication of details of the contact point by the investor to the disclosing market participant can facilitate a smooth sounding process. To ensure effective compliance with the regime, we advise firms to consider whether staff receiving sounding approaches are properly trained and aware of their obligations under MAR and related guidelines.

Models dependent on a gatekeeper engaging in a high-level, 'no-names' discussion with the relevant portfolio manager ahead of accepting the sounding should take care to only disclose information that is necessary to establish whether the approach should be accepted. Firms should take particular care when discussing markets that have few actors and where information could reasonably be used to identify the security in question.

Depending on the approach, a declined wall-crossing could still convey inside information. This could occur where the sell-side making contact only initiates soundings for a small number of securities. In line with investors' responsibility to assess for themselves whether they are in possession of inside information, firms

should consider whether a declined wall-cross has had the effect of wall-crossing the investor and apply the relevant controls.

Record-keeping

Good record-keeping is key to gaining protection under the market soundings regime. The use of recorded lines is one way to ensure effective compliance in this area. Firms can use written minutes agreed by the disclosing party and the sounding recipient as an alternative method. We noted that fewer than half of the investors responding to our survey reported consistently using recorded lines to document soundings. We urge market participants to consider the most effective way of achieving compliance for their business model.

We noted a mixed record among investors of documenting declined sounding approaches. Firms may wish to consider maintaining a detailed record of these conversations, along with an explanation of why the sounding was declined, as good practice.

'Cleansing' following a sounding

Our review indicated that informing market sounding recipients when information disclosed during a sounding ceased to be inside information ('cleansing') was working well for most transactions. Seventy percent of investors who responded to our survey were either satisfied or very satisfied with the disclosing market participants' procedures for cleansing. Robust cleansing procedures are crucial in assuring investors that they are able to lift any trading restrictions and in maintaining confidence in the sounding framework.

Firms spoke of using 'public' or 'private' cleansing depending on the nature of the sounding. Public cleansings can take the form of a statement published through a regulatory information service provider or a press release. Private cleansings often take the form of an internal communication to investors. To ensure a sounding operates as smoothly as possible, we advise firms to agree cleansing strategies as early as possible ahead of a transaction and to be clear in their approach. This could include consideration of how cleansing will operate if a transaction fails or is 'parked'.

Our review was completed against a backdrop of high demand for new issues and low interest rates. We heard that these market conditions were rendering market soundings less necessary, particularly for investment-grade bonds. As a result, the soundings framework established in MAR may not yet have been stress-tested by market participants. Firms may wish to consider whether their approaches to undertaking or receiving market soundings can easily adapt to changing market conditions, including a less favourable market for new issues or an uncertain trading environment.

Insider lists

One of the key themes in MAR is the identification and control of inside information. Everyone from issuers, their advisors, the sell-side and the buy-side, has an obligation to identify when they are in possession of inside information and to control it.

Inside information can arise in a variety of ways. It can be created through receipt from an outside source, a firm's own actions or through collating pieces of information from different sources. Market participants should remain vigilant and ensure that staff are trained on how to identify and respond to inside information. Anticipating likely sources of inside information can assist in fulfilling this obligation.

Once inside information has been identified, issuers are required by MAR to create and maintain an 'insider list'. Insider lists are important tools for regulators when investigating possible market abuse. We attach importance to receiving the mandated template in a complete and timely fashion. The lists are also important for market participants in demonstrating that they have robust systems and controls in place to comply with MAR.

Each time new inside information is identified, a new section should be added to the insider list. Each section should contain details of everyone who has access to that inside information who are working for the issuer under a contract of employment, or otherwise performing tasks through which they have access to the inside information. Issuers are obliged to take reasonable steps to ensure that those on the list with access to inside information acknowledge their duties and are aware of the sanctions for insider dealing and the unlawful disclosure of inside information.

We have observed varying quality in the insider lists we have received to date. We encourage issuers to ensure that all staff with access to inside information are included on the insider list. This includes those who have accessed information according to electronic access logs. The list should include all information as set out in templates in the Annex of Commission Implementing Regulation (EU) 2016/347. We expect all fields, including relevant personal information, to be completed.

The European Securities and Market Authority's (ESMA's) Q&A 10.1 and 10.2 states that an issuer is not responsible for maintaining an insider list for persons acting on its behalf or account, such as advisers or consultants. According to this Q&A, any persons acting on the issuer's behalf or account is required to draw up, update and provide the relevant authority with their own insider list upon request.

We are aware that some intermediaries, including investment banks, are receiving requests for their employees' personal information to assist the issuer in fully populating its insider list. In this scenario, we encourage intermediaries to provide a contact point and advise that they will provide a complete list to the relevant regulator upon request.

Many issuers (63% from our survey) are choosing to use a permanent insider list to document those individuals who have access at all times to all inside information within the issuer. When used appropriately these lists can be a valuable tool to reduce administrative burden. We expect participants to ensure that the number

of employees captured on such lists is not disproportionately large and remains restricted to employees who have access at all times to all inside information. This allows authorities to appraise who had access and when. Those who do not have access at all times to all inside information should be captured in the deal-specific or event-based insider list.

Other types of lists

During our review, we heard that some participants are using 'above-the-wall' lists. In some cases, these lists operate as default permanent insider lists. Other lists were being used to record individuals who can be approached for wall-crossings while also maintaining a separate permanent insider list. Participants should be clear on how any list is used and ensure its use remains appropriate, with the required controls in place.

To ensure that we are able to proceed with cases effectively, we request that completed insider lists be returned within 2 days of a request and that a full chronology is sent within 5 days. Most participants we spoke to were confident they could meet these timescales, though this was not universal. Of the issuers that responded to our survey, 34% reported being able to submit a full list in 1 day, with 59% taking 2 to 3 days. We are aware that some issuers have put service-level agreements in place with their Human Resources departments to ensure the timely production of personal data, which participants may wish to consider as good practice.

Obligations for issuers under MAR

We would like to remind issuers of the importance of maintaining adequate procedures, systems and controls to comply with their disclosure obligations under MAR. As part of this, issuers should ensure that they have the systems and controls for identifying and disclosing inside information.

Governance processes for assessing whether information meets the threshold for inside information and for determining the timing and content of announcements can vary. However, disclosure committees can be an effective forum for discussion and challenge. Additionally, issuers can seek the views of advisers. Of the issuers that responded to our survey, 93% reported using internal governing bodies, including disclosure committees, to make this assessment, while 89% used external counsel, including legal, advisory and corporate brokers.

Issuers should ensure they can identify and assess whether they have information that could meet the test for inside information outside of normal reporting timetables and in an accelerated manner. Where information that may not be in line with market expectations comes to light, for example in weekly sales reports or when preparing monthly management reports, this should be immediately investigated. If the outcome is that the issuer believes its historic or expected performance may not be in line with market expectations then the Company will need to consider its disclosure obligations under Article 17 of MAR.

For information deemed to meet the conditions of inside information, issuers are also required to maintain an insider list. Of the firms that responded to our survey, 93% reported using additional lists, including confidential/project/prohibited dealing lists, to record individuals who may have access to confidential information that has not been deemed inside information. This can be an important tool to aid compliance and ease the transition where confidential information meets the threshold for inside information.

MAR requires all persons professionally arranging or executing transactions to detect and report suspicious transactions that could constitute market abuse. ESMA's Q&A 6.1 has confirmed that this obligation extends to non-financial firms that, in addition to the production of goods and/or services, trade on own account in financial instruments as part of their business activities. While 74% of issuers responding to our survey considered this requirement inapplicable to their business, we encourage firms to review their obligations to assess whether they are in scope of this requirement.

Next steps

We will continue to work closely with market participants to ensure a consistent, effective implementation of MAR.

Manufactured Credit Events

We have observed recent behaviour in the CDS market that appears to involve intentional, or 'manufactured', events. This behaviour can severely harm confidence and trust in the credit derivatives market, including single-name CDS and indices. Whilst the behaviour observed so far has not directly impacted the UK, the CDS markets are global. Therefore, behaviours can transfer quite easily and become a concern for us.

As FCA CEO Andrew Bailey said in a Bloomberg interview earlier this year, we feel this behaviour is on 'the wrong side of the line' and goes against the intended purpose of these instruments. Manufactured credit events may in certain circumstances constitute market abuse by the involved parties – both the CDS counterparty and the firm referenced in the CDS.

We have been speaking with firms, the International Swaps and Derivatives Association (ISDA) and other regulators about this. We support the work undertaken by the industry and ISDA to address behaviour which undermines the functioning of CDS and the integrity of our financial markets, and we look forward to swift and effective action to avoid the spread of this unwanted activity into our markets.

We will investigate and assess any suspected market abuse we find, and take any appropriate action.