IMPLICATIONS OF COVID-19 ON MARKET ABUSE MONITORING

The COVID-19 pandemic and consequent governmental restrictions have resulted in financial institutions allowing employees to work remotely from home. One business area where this has been problematic in the past is that of front office trading due to institutions restricting traders' the ability to access the market from anywhere other than office premises, to ensure effective oversight in order to comply with regulatory requirements.

Advances in technology such as fast broadband connectivity now enables traders to access all the necessary market data, liquidity aggregators, and execution venues from any location. Homemade workstations dubbed "Rona Rigs" (made up of giant high definition screens) and secure recorded phone lines have allowed traders to set up trading desks at home enabling them to continue to operate. As institutions have moved to offsite working, the United Kingdom's Financial Conduct Authority (FCA) has been particularly focused on ensuring that market integrity is preserved. The FCA has made it clear that firms should continue to take all necessary steps to prevent market abuse.

Market Abuse Regulation

- The Market Abuse Regulation (MAR) came into effect on 3 July 2016 in the UK and is enforced by the FCA. It aims to increase market integrity and investor protection.
- Breaches of MAR can attract unlimited fines, or even prohibit regulated firms or approved persons from undertaking regulated activity. A criminal prosecution for insider dealing (under the Criminal Justice Act) can incur unlimited fines and sentences of up to 7 years.
- MAR extends scope to new markets, new platforms and new behaviours and the significant introduction of monitoring trade orders as well as executions.
- Firms must have safeguards in place to identify and reduce the risk of market abuse.

THE FCA'S EXPECTATIONS

A number of statements by the FCA have confirmed that regulatory compliance expectations will not be relaxed; instead, firms are required to adapt their existing systems and controls to adequately address the new risks posed by employees working from home or alternative locations. The FCA has made clear that it is *"actively reviewing the contingency plans of a wide range of firms,"* including an assessment of *"operational risks,"* with an expectation that *"firms [are] to take all reasonable steps to meet their regulatory obligations".* [1]

The FCA has highlighted market abuse as a continuing high-risk area and requires firms to *"take all steps to prevent [against] market abuse,"* which may include paying more attention to compliance measures with *"enhanced monitoring, or retrospective reviews."*

Mark Steward, the Financial Conduct Authority's executive director of enforcement and market oversight said recently that one of the fundamental objectives of the senior managers regime was to ensure that senior managers had better oversight of what was actually happening beyond and below their line of sight: *"That meant ensuring that there were systems and control [in place] that were able to do that … in a modern working environment, those systems and controls should be able to operate regardless of where people actually happen to be sitting," … "I will assume the systems and controls that have been put in place before the lockdown are able to operate during the lockdown."* [2]

The FCA have reiterated to firms their regulatory obligations as a direct consequence of institutions allowing front office personnel to operate remotely

[1] FCA statement – "Financial crime systems and controls during coronavirus situation" 6th May, 2020.

[2] Financial crime systems and controls during coronavirus situation 6th May, 2020

[3] FCA statement – Financial crime systems and controls during coronavirus situation – 6th May, 2020

thereby potentially increasing the risks of market abuse occurring. Consider the scenario where a member of staff is in possession of sensitive inside information and is working from home, the risk of inadvertent disclosure to family, housemates or others is significantly increased without the compliance monitoring infrastructure that is typically present in a firm's office.

Clearly with institutions having staff spread out across different locations, it is likely to be more difficult to conduct trade surveillance and monitoring, increasing the risk that potentially manipulative trading going undetected and in turn not reported to the FCA as is required. The FCA has reiterated that it is important that firms remain vigilant to new types of fraud and amend their control environment where necessary to respond to new threats. This should include the timely reporting of Suspicious Activity Reports (SARs) of any new threats. [3]

ESMA STATEMENT

The European Securities and Markets Authority (ESMA), in its initial statement on the COVID-19 pandemic on 11 March, echoed the position of national competent authorities like the FCA, in that ESMA expects financial market participants, including infrastructures should be ready to apply their contingency plans, including deployment of business continuity measures, to ensure operational continuity in line with regulatory obligations; and it expects issuers should disclose as soon as possible any relevant significant information concerning the impacts of COVID-19 on their fundamentals, prospects or financial situation in accordance with their transparency obligations under the Market Abuse Regulation. [4]

THE CHALLENGES IN A COVID DISRUPTED ENVIRONMENT

Due to the market volatility created by the COVID-19 crisis and with employees and trading teams more likely to be working remotely with less supervision (and potentially in some circumstances without recorded phone lines) these conditions will continue to have an impact on market abuse risks and related surveillance operations. Additionally, such working conditions may also disrupt the smooth functioning of firms' compliance and trade surveillance teams and broader systemic controls, increasing the challenges associated with monitoring market abuse risks and reporting suspected instances of market abuse.

It is important for institutions to be prepared for market abuse activities to be hidden among the increased trading volumes in the present volatile market. Such circumstances arguably provide greater opportunity for the unscrupulous to commit market abuse activity. In this environment, institutions need to be extra vigilant and are required to challenge explanations in relation to what may appear to be unusual trading behaviour and establish that such trading patterns are indeed reflective of market conditions. This can be done by looking at behaviour relative to peers (internally and externally) and creating a set of indicators relating to: Trade execution trends (including but not limited to frequency, average trade size and daily maximum size) and Order trends (average order size, level of deviation versus peers and level of participation versus the market).

The FCA and ESMA have respectively made clear that they expect firms to take reasonable steps to meet their regulatory obligations.

With Market Abuse being at high risk during the crisis due to changed working arrangements. Firms are therefore required to take all necessary steps to prevent it occurring with enhanced monitoring and retrospective reviews.

REDUCING THE RISKS OF MARKET ABUSE

It is important that institutions apply appropriate measures reflecting the risks associated with their current working arrangements and put in place a reasonable set of measures to ensure the continuation of a strong control environment thereby reducing the risks of market abuse.

Some suggested steps that institutions could take:

- Assess whether compliance and trade surveillance teams are adequately resourced throughout the

[4] ESMA recommends action by financial market participants for COVID-19 impact – 11th May, 2020

period of disruption, especially where there are absences due to illness, and in instances where individuals are working from home that they have access to the required tools and resources in order to monitor off-premises trading effectively;

- Ensure that telephone lines and email mailboxes that are used for escalation purposes, such as whistleblowing hotlines, remain open and real time monitored;
- There is effective record keeping, including continuing to record all telephone calls (although the FCA has accepted that some scenarios may emerge where this is not possible);
    - In most organisations desktop or dealer phone systems are available as a "soft-phone" (software on a remote computer). Using the soft-phone ensures all communications can be monitored and recorded as if a trader was present in the office.
    - Mobile telephones issued to trading staff should be on airtime networks where recording of all calls is enabled.
    - Traders should be reminded that use of private mobile phones should be restricted whilst trading, reflecting restrictions on use of private mobile phones on trading floors.
- Re-circulate all relevant policies and procedures to all impacted employees;
- Electronically train staff (where possible) on all the relevant risks of working from home and how staff can mitigate those risks, particularly in relation to keeping information secure and confidential; and
- Institutions need to ensure that they continue to make suspicious transaction reports to the FCA under the suspicious transaction and order report (STOR) regime and to the National Crime Agency (NCA) under the suspicious activity report (SAR) regime, where required.

The FCA has made clear that it is continuing to monitor for market abuse and will take action if considered necessary, so it is vitally important that institutions do not let new working arrangements weaken existing systems and controls that they have in place.

CONTINUING CHALLENGES WITH MARKET ABUSE MONITORING

Despite the fact that the Market Abuse Regulation came into effect in July 2016 a significant number of institutions still apply largely manual and labour intensive post trade surveillance processes. ECNs (Electronic Communications Networks), and Exchanges publish millions of messages per second, creating huge volumes of data making it a challenge for compliance and surveillance teams to detect abusive behaviours without automation. Most firms still lack the capability of linking various pieces of structured and unstructured data together in one place to allow them to be able to see a comprehensive picture of a traders' market(s) and communications activity.

Since reviewing every communication would be too time consuming most institutions apply a random sampling method which keeps the number of data points to be reviewed at a manageable level, but unfortunately this leaves the compliance and trade surveillance review process entirely to chance. This type of sampling method fails to completely address key monitoring criteria and genuine market abuse events (in some instances) are not identified and investigated in a timely fashion as is required by MAR.

DETECTING BEHAVIOURS

Market manipulation typically falls into three types of behaviour:

SPURIOUS BID / OFFERS	Manipulating the price, making bids / offers at prices at which it is not intended to execute. **Layering; Spoofing; Smoking**
PUBLICISING BUYS / SELLS	Creating a misleading impression of trading activity or price movement, engaging in multiple transactions which are publicly displayed. **Painting the Tape; Wash Trades**
DELIBERATELY DISSEMINATING FALSE INFORMATION	Taking a long or short position, and undertaking further trading activity and disseminating misleading positive or negative information about an instrument with a view to artificially moving the price up or down, prior to executing a trade to take advantage of that artificial price movement. **Pump and Dump; Trash and Cash**

HOW TO ENSURE MORE EFFECTIVE COMPLIANCE WITH MAR?

Financial institutions need to adopt a comprehensive monitoring program which automates the surveillance of all trading activity.

Manual and or basic automation of processes tends to yield a disproportionately high number of false positives which are extremely time consuming to investigate for surveillance teams, compliance and business units. Therefore, in our view surveillance algorithms are most effective when coupled with intelligent calibration reflecting an institution's trading patterns, behaviour of its trader(s), and demonstrating how a firm and its traders engage in the wider market, across various instruments types.

The use of machine learning can allow adaptive algorithms to automatically recalibrate as market volatility or trading patterns change, since these are the precise circumstances in which risk of market abuse is the greatest. Hence, it is very important that adaptive methods are fully auditable and easily understood by both internal surveillance and management teams, and regulatory bodies.

The largest category of market abuse risks tend to be the most difficult to detect, examples of these include:

- **Market abuse conducted across multiple execution venues, through the collusion of multiple traders across several trading desks within an organisation.**
- **Manipulation of illiquid instruments in emerging markets.**
- **Manipulation of price(s) through high frequency order entry during volatile periods.**

In addition, institutions should consider comprehensive data capture of all market data, market orders, trading position data, and client trades the minimum requirement for record keeping purposes. The availability of a complete store of aggregated data enables firms to have a more effective real-time and post-trade surveillance monitoring process. It also serves as a critical tool in defending and determining whether activity was abusive or compliant with regulatory requirements.

CONCLUSION

With institutions allowing traders to transact remotely from home during the COVID-19 crisis, this has exponentially increased the problem of effective market abuse monitoring. Potentially allowing bad actors to take the opportunity to conduct abusive behaviour.

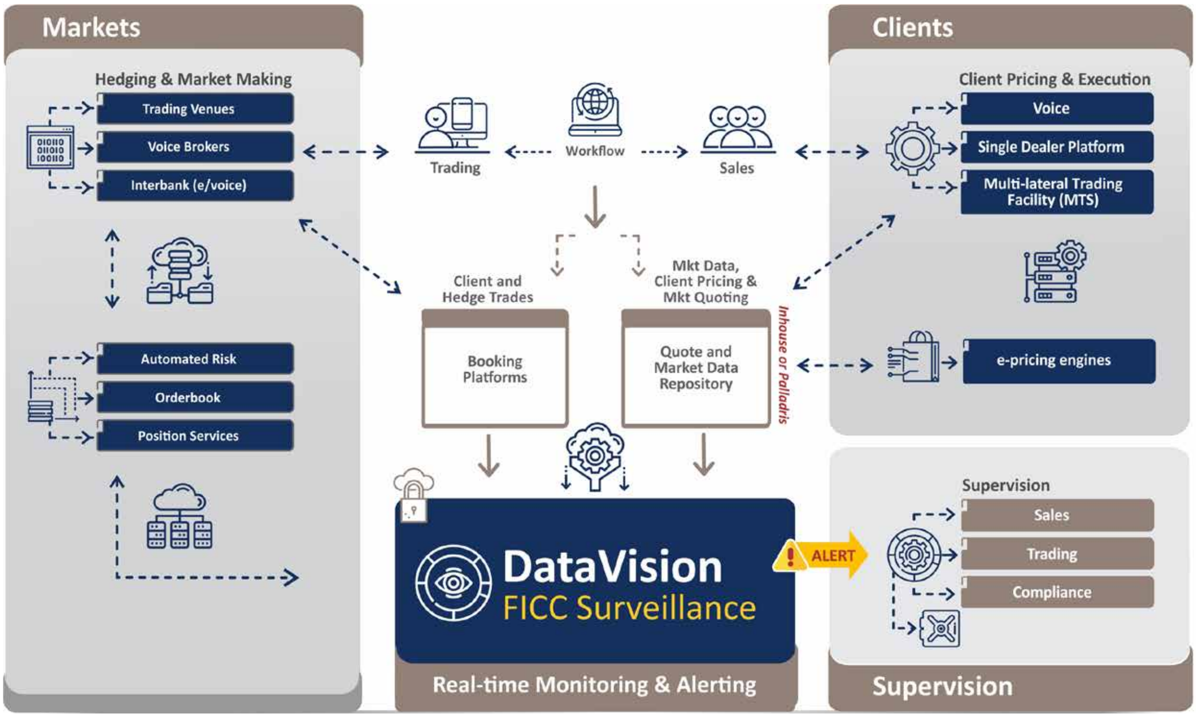
Even before the crisis evolved there was a need for an automated tool that could consolidate the numerous forms of data that are generated by the front office and to assist compliance and trade surveillance functions to effectively identify red flags, this has now become even more critical. Clearly, the quicker a market abuse event is discovered, whether it is an intentional or accidental event(s) the sooner the matter can be investigated and reported to the FCA in line with a firm's regulatory obligations. It cannot be stressed enough that prompt action assists institutions to prevent any further abusive behaviour occurring and helps to contain and manage the resultant damage, from a regulatory, financial and reputational perspective.

We are available to discuss the matters raised in this client note relating to Market Abuse Monitoring and assist clients to implement an effective surveillance strategy.

In response to the present restrictions, we are providing our services across virtual meeting platforms, utilising whiteboards, data rooms and other productivity tools.

Call us now on: +44 (0)20 3900 0366

At Palladris we have designed a framework to monitor and detect abusive behaviours across Fixed Income, Currency, and Commodities markets on a real-time basis.



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Contact Palladris for guidance as to how your firm can more effectively meet its regulatory obligations under the Market Abuse Regulation.

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