The requirement for firms to have adequate systems and controls to identify, mitigate and detect market abuse risks remains at the forefront of consideration for the Financial Conduct Authority (the “FCA”). This was highlighted in the notice published on 22 February 2016 to W H Ireland Limited (“WHI”) (the “Final Notice”). This note highlights the importance of actively managing the risk of market abuse and conflicts of interest and seeks to provide firms with some practical guidance.

The WHI case

WHI is a wealth management and corporate broking firm which the FCA found had failed to ensure that it had adequate systems and controls in place to identify, mitigate and detect market abuse risks. The FCA imposed a financial penalty of £1.2m and restricted the firm’s corporate banking division from taking on new clients for a period of 72 days as a disciplinary measure. The failings identified by the FCA between 1 January and 19 June 2013 amounted to a breach of Principle 3 of its Principles for Businesses which requires that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. The specific failings included:

- **deficient compliance oversight** – absence of sufficient monitoring and oversight of market abuse controls, most notably post-trade surveillance
- **poor training programmes and records** – lack of formal training programmes on market abuse risks and lack of record keeping of training received by staff
- **inadequate market abuse controls** – weak controls to identify, mitigate and detect the risk of the illegitimate transfer or use of inside information especially through personal account dealing by staff
- **conflict of interest policy failures** – ineffective written conflicts of interest policy and inadequate record keeping of identified conflicts of interest arising from the types of service or activity undertaken by the firm.

During this period WHI managed approximately £2.5bn of assets for 9,000 private wealth clients and had 87 corporate broking clients. Due to the firm’s failure to implement sufficient systems and controls to identify, mitigate and detect market abuse risks in respect of the information provided by these clients.

In addition, the FCA found that WHI had also breached specific Conflict of Interest rules of the Senior Management Arrangements, Systems and Controls sourcebook (Chapter 10, “SYSC”).

The failings were considered to be particularly serious by the FCA for a number of reasons:

- **range of services and activities within WHI’s business model** – wide range of services across both the public and private side (corporate finance, acting as a NOMAD, market making and private client broking) which received and handled inside information which gave rise to extensive market abuse risks.
A potential impact on the market – given the diversity of WHI’s business activities the misuse of inside information could have had a significant impact on a large number of market participants.

Awareness of risk in industry and WHI itself – the FCA (and its predecessor, the FSA) had issued a significant number of communications on this topic to the industry and WHI had been subject to a skilled person review in this area.

In July 2013 the FCA appointed a skilled person to review WHI’s market abuse systems and controls including the handling of inside information, personal account dealing, oversight by compliance and senior management and training. The report issued in August 2013 detailed a number of recommendations which were to be implemented by WHI within three to 12 months. In July 2014 WHI commissioned a further report by the skilled person to assess the implementation of the recommendations which concluded that some recommendations had not been adequately implemented within the appropriate time frame. The FCA Director of Enforcement and Market Oversight, Mark Steward, commented in the FCA’s press release that “it is one thing to be given a chance; for the chance not to be taken up is especially culpable.”

WHI received a 20% Stage 2 settlement discount, without which the financial penalty would have been £1.5m and a business restriction of 90 days. This is only the second time a business restriction pursuant to section 206A of FSMA has been imposed by the FCA as part of an enforcement outcome.

Managing the risks of market abuse and conflicts of interest

The Final Notice highlights the importance of actively managing conflicts of interest throughout the entire business model from the identification of conflicts, policies and procedures to manage, record and mitigate conflicts and the education of staff on conflicts of interest (including the identification, management and escalation of conflicts) to mitigate the risk of market abuse. The following is key guidance arising from the Final Notice.

Firms should continually review their business model to identify where conflicts of interest may arise (whether crystallised or potential) and ensure that their policies and procedures are robust enough to mitigate the identified risks. The WHI case provides a useful example of real conflicts which can arise when operating both on the public and private side of markets and the market abuse risks this gives rise to. The materiality of any conflicts of interest can be impacted by the nature, complexity and scope of the business model or other factors such as timing (for example, trading ahead of an acquisition by a corporate client). The following steps outline the continuous cycle of assessment a firm should undertake in respect of market abuse and conflicts of interest:

Stage 1 – Identify

The assessment for material conflicts (which could cause material damage to the interest of a client SYSC10.1.4R) should be undertaken on a continuous basis. It should be clear to staff how any conflicts of interest should be reported and escalated. Clear responsibility for the management of the conflicts of interest process needs to be allocated to an appropriate member of staff, with oversight by senior management.

Any risk assessment process needs to be informed by management information about any relevant conduct risk issues which are detected (for example breaches of information barriers).

Firms are required to record all material conflicts of interest in a register (SYSC 10.1.6R). Whilst the form of the register is not prescribed, the register should list the conflicts, the activities which give rise to them and be regularly updated.
Stage 2 – Mitigate the risks identified

Firms should consider what systems and controls are needed to mitigate the conflicts of interest which have been identified through the review process. Firms are under an active obligation to take all reasonable steps to prevent the identified conflicts of interest causing damage (SYSC10.1.7R). This is not a perfect science and even the most robust systems will not eliminate 100% of the risk, however a firm must be able to demonstrate that its approach was reasonable. Specific issues to consider include:

- **policies and procedures** – should be clear, informative and address each of the risks identified

- **information classification** – consider how information is classified, utilised and handled throughout the business. Consider the systems and controls needed to control legitimate information flows both internally and externally (for example wall-crossing clients) and those needed to prevent the illegitimate transfer of market sensitive information. Consider how the geography of the business increases the risk of information transfers (WHI’s offices did not physically separate employees working on the private and public side of its business)

- **personal account dealing** – although connected to the issue above of information classification and use, firms must ensure that they have robust systems and controls around personal account dealing (COBS 11.7.1R). This risk is inherent in any business which handles market sensitive information which employees could abuse for personal gain. Firms should ensure that their personal account dealing rules:
  - are **clear and practical** – consider the scope of the policy and any restrictions (all personal account dealing or only dealing in specific securities)
  - apply at all times – it must be clear to staff that the rules apply at all times and that personal account dealing must be reviewed annually at a minimum
  - require a **yearly attestation** – although not a regulatory requirement, firms should consider implementing a yearly attestation process for personal account dealing for relevant staff (which will inform the continuous assessment of conflicts of interest). Any attestation sought must be clear and without ambiguity as to the scope of the policy and the declaration sought. This approach will enable a firm to demonstrate the importance it attaches to actively managing this high risk area to staff, clients and the regulator.

- **training and competence** – firms must ensure that staff in the business and their control functions understand their obligations in respect of market abuse and the importance of identifying and escalating any potential conflicts of interest. Firms should ensure that regular training is provided in respect of market abuse (where attendance is recorded and competency tested) rather than relying on informal training or high level descriptions in policies and procedures. Training must draw out the risks which are inherent in that particular firm’s business model (as identified and reviewed at Stage 1 above) and detail the mechanisms by which concerns can be escalated to senior management

- **governance and oversight** – senior management must maintain oversight and ownership of market abuse risks within the business. This responsibility must be clearly scoped and articulated. Firms should ensure that appropriate management information is produced in respect of real time market abuse issues in order to ensure that the senior management can use this to inform any risk assessment processes, testing or improvements needed for its systems and controls and to ensure the delivery of any remediation required.

Stage 3 – Detecting areas of crystallised risk

The existence of robust systems and controls will not absolve a firm from actively monitoring its staff in order to identify, detect and deter any misconduct. However the level of risk within a firm’s business model will ultimately inform the extent, frequency and type of monitoring needed to detect and investigate conduct risk issues. Monitoring and oversight will be required across all three stages of this process to ensure that all material risks are identified, systems and controls are robust and complied with and to detect any market abuse which might have occurred (notwithstanding the satisfactory completion of Stage 1 and Stage 2 above). Firms should consider the
following issues:

- **compliance monitoring** – these processes should ensure that compliance monitoring is conducted by staff who are adequately trained in market abuse issues within the context of the firm’s business model. Key issues for firms to consider are:
  
  - **scope of monitoring** – this should be informed by the inherent risks identified in the firm’s business model and should be tailored accordingly
  
  - **real time monitoring** – monitoring needs to be timely to detect crystallised risk and to enable the firm to meet its regulatory reporting obligations (for example Suspicious Transaction Reporting). During the relevant period WHI’s compliance monitoring function had a 60 day backlog of trade data to review
  
  - **consistent and informed approach** to monitoring – compliance staff need to be adequately trained to undertake monitoring activities and to analyse the trade data or additional information which is available to them (for example any additional information which is provided by automated surveillance systems)

- **checking the checker** – firms must achieve a balance between reliance on automated surveillance and manual monitoring. Consider how to achieve a reasonable level of quality assurance and to enable the monitoring process to be informed by other relevant information which might impact the risk profile of the review, for example:
  
  - **unusual trading patterns** in certain securities or by certain members of staff (either on behalf of the firm or in respect of personal account dealing)
  
  - **unusual patterns of behaviour** by certain staff members including erratic working hours, sudden increased (or decreased) trading activity or trading in different asset classes
  
  - **during certain time periods** (for example prior to a large market event such as an IPO) the risk profile of trading in certain securities may increase

- **connecting the dots** – firms need to ensure that the information gathered throughout Stages 1, 2 and 3 of this continuous cycle are captured, escalated and considered as part of a continuous programme of risk management. This approach should assist firms to demonstrate to the FCA that they have robust processes in place to identify, mitigate and detect market abuse and that these processes are continually evolving to adapt to changes in the firm’s risk profile.

**The implementation of remediation**

The Final Notice highlights that firms should ensure that any recommendations and resulting remediation commitments, which result from a skilled persons review (pursuant to section 166 of FSMA), are implemented in a timely and robust way. In addition where a firm has received expert views from an external third party or indeed an internal review (for example through an internal audit process) any agreed recommendations must be recorded, monitored by senior management and delivered in a timely way. Firms should proactively engage with the FCA to report on the progress of any remediation programmes and raise any concerns about delivery (including feasibility or timing) as soon as possible in order to maintain an open and cooperative dialogue.

**What next for asset managers and the wider industry?**

The issue of conflicts of interest within the asset management industry and financial services firms generally remains an area of focus for the FCA¹. Asset managers should also take care to assess compliance with their fiduciary duties to manage conflicts of interest as well their regulatory duties as outlined above.

¹ [http://www.fsa.gov.uk/static/ubs/other/conflicts-of-interest.pdf](http://www.fsa.gov.uk/static/ubs/other/conflicts-of-interest.pdf)
Further firms should take this opportunity to review (and if needed update) their policies and procedures in advance of the implementation of the Market Abuse Regulation which comes into effect on 3 July 2016. We will be holding a series of client call covering different aspects of the Regulation during April – further details to follow.

For more information on MAR please visit elexica.com

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