

Market Watch

**Markets Division: Newsletter on Market Conduct and
Transaction Reporting Issues**

Issue No.15 February 2006



Introduction

This is our fifteenth Market Watch newsletter. If you wish to join our email list to receive future editions, please contact us on market.watch@fsa.gov.uk. It is also available on our website at: www.fsa.gov.uk/marketconduct/

Misleading Primary Debt Issuance Disclosures

Over the past few months, we have had a number of discussions with market practitioners about standards of disclosure in the primary debt market, and whether some practices may have a misleading effect on the market. We have discussed in particular a mechanism whereby some sole lead managers have sought to attribute 'notional' fees to bought deals where no fees were in fact paid. By representing that fees had been paid, the sole lead manager encourages the market to believe that the transaction was executed on a book build basis rather than a bought basis. This can benefit the sole lead manager by preventing the market from becoming aware that, as the transaction was a bought deal, the sole lead manager may have an unwanted residual position in the new issue. We are aware of variations of this technique, which is not restricted to deals arranged by a sole lead manager. All involve deliberate disclosure of inaccurate fees and commissions.

The FSA takes the view that this practice results in misleading information being conveyed to the market about the fees paid by the issuer, the issue price, and potentially the deal structure used to price the bonds, and is likely to breach the Financial Services and Markets Act 2000 and rules made under Part 6 of the Act.

Firms should also be making full disclosure of fee or expense rebates to issuers. We note that Recommendation 1.8 of the IPMA Handbook, published by the ICMA, recommends that 'if a lead manager reimburses the issuer for any material amount of its fees or expenses directly associated with the issue of bonds, such fact should be disclosed in the offering circular or pricing supplement, as appropriate'.

Senior management should be aware of the reputational and legal risks created when appropriate disclosure is not made to the market. Acceptable market practice is to ensure that adequate and precise disclosure of all material terms of a transaction is made.

Short Selling – a risk to the market?

As set out in the FSA's Discussion Paper on Short Selling (October 2002) and the Feedback Statement (April 2003) the FSA's view remains that short selling is a legitimate investment activity which plays an important role in supporting efficient markets. We recognise, however, that short selling may also pose risks to the market – including contributing to the potential for disorderly trading, increasing the possibility of short-term price volatility, being used in manipulative trading strategies and leading to settlement disruption.

The last issue arises on occasion, particularly in less liquid stocks, when significant short selling has led to failure to deliver the required stock, causing difficulties for purchasers. Since the FSA's short selling review in 2002/03, both the London Stock Exchange and virt-x have agreed to issue Market Status Messages for securities experiencing a significant proportion of settlement failures. The intention of these messages is to notify the market of building settlement problems and thereby reduce the potential risk of a disorderly market. These Market Status Messages are sent to member firms of the exchanges. Where a Market Status Message has been issued as a result of building settlement problems, there is a requirement for authorised firms to comply with FSA Principles for Businesses, in particular Principle 1 (Integrity) and Principle 6 (Customers' Interests). This requirement addresses the risk that the clients of member firms may experience delays in the timely settlement of their securities.

The London Stock Exchange has recently published a Stock Exchange Notice and Supporting Guidance reminding Member firms that, when short selling on a substantial scale, they must ensure that they have a clear settlement strategy for settling these short positions. The guidance also states that Member firms who do not believe they will be able to fulfil their settlement obligations should not continue to pursue their short selling strategy. The FSA fully supports this Notice and guidance. ([Hyperlink to Notice and Supporting Guidance](#))

Transaction Reporting breaches

You will be aware from press reports that last year that we fined three FSA-authorised firms for breaches of Chapter 17 of the Supervision Manual (The Transaction Reporting Rules) and Chapter 15 of the Supervision Manual (Notifications to the FSA). These fines demonstrate that we take a very serious view of firms who fail to report transactions in line with our rules. We sent a letter in December 2005 to the chief executives of firms that report transactions to us, again highlighting the importance of accurate and complete transaction reports: www.fsa.gov.uk/pubs/ceo/transaction_reporting.pdf.

Transaction reports play a key role in our market abuse monitoring work. In addition, implementing the Markets in Financial Instruments Directive (MiFID) will bring an added dimension to the topic of transaction reporting. This is because we will be required to share this data with other competent authorities.

We would urge firms to review their internal transaction reporting procedures and systems on a regular basis. With this in mind, the Transaction Monitoring Unit is happy to provide firms with a sample of reports we have received in order for firms to check those reports against their own internal records.

Transaction Reporting System (TRS)

Since mid-November 2005 firms reporting via our Direct Reporting System (DRS) have been migrating over to our new Transaction Reporting System (TRS). We would like to thank those of you who have already completed your migration, and those of you in the process of migrating, for your continued efforts and cooperation.

We expect all firms currently using DRS to migrate over to TRS no later than mid-April 2006. We intend to switch off DRS at or around this time, so if your firm is still using DRS then, you may have to assume proportionate responsibility for the additional costs associated with running DRS when other firms are using TRS. If you have concerns about your ability to meet this time frame, please contact the Transaction Monitoring Unit via email at TMU@fsa.gov.uk.

Why are we making this change? TRS offers a number of advantages over DRS. As a web-based system, TRS does not require you to install any software. TRS will also provide you with far more management information than you currently get from DRS. Transaction reports sent to TRS are validated against

certain FSA reporting rules and you will receive feedback on any transaction reports that do not meet these rules. TRS therefore makes it easier for firms to meet their FSA reporting requirements. For more information about TRS please launch the Computer Based Training (CBT) package by going to the TRS launch page at <https://trs.fsa.gov.uk/>.

Once you have read through the CBT, please call the TRS Service Desk on 0870 0130 467 and quote your FSA Reference Number to register for access to TRS.

Once you are live on TRS, to cancel your DRS licence(s), please remember to email the DRS Help Desk at INVMCDServiceDesk@CapGemini.co.uk using the following subject title: 'Deactivate DRS licence number(s) by close of business 'dd/mm/yyyy''. This will also ensure that your annual licence fee for DRS is stopped.

When you have deactivated your DRS licence(s) you may also wish to contact British Telecom (BT) to cancel your BT GNS line for DRS. Please note that unless it is reasonably practicable to do so, you are not required to report via an alternate reporting system if there is a reporting system failure (please see SUP 17.7.10 Failure of reporting systems for further information).

FSA Thematic Review of Anti-Market Abuse systems and controls at Retail Brokers

During the Autumn/Winter of 2005, our Market Monitoring Department met several retail firms to discuss what changes to internal controls, if any, had been made following the implementation of the Market Abuse Directive which came into force in the UK on 1 July 2005. We visited 13 firms in total, ranging from large to small stockbrokers and medium to small CFD/spreadbet providers. We are grateful to those firms who took part in this exercise.

There was a wide range of practice between the firms – with the differences, perhaps not surprisingly, most stark between larger and smaller firms. For instance, in a couple of smaller firms no training on the Market Abuse Directive had yet been given. While some firms had a reasonably in-depth understanding of the Directive and the requirements that it placed on firms and the individuals at the firm, others had only a very basic understanding and need to do more to bolster this.

We thought that it would be helpful to provide some feedback, on a no names basis, to the market through this newsletter and also to plan to present our findings at a forum facilitated by APCIMS and the Spreadbetting Trade Association on 14 March 2006 12-2pm. Our objective is to share ideas and provide some good examples of the controls that firms put in place for implementing the Market Abuse Directive. We would encourage firms to undertake a self assessment against these points and to consider if there are any areas where they could strengthen controls or enhance staff understanding.

The following are some of the good practices identified from our visits.

Compliance controls/monitoring

The introduction of a mandatory suspicious transaction reporting system was one of the Directive's major innovations, so this was one of the main areas we focused on. Most firms we visited stated that they had at least some form of manual transaction monitoring system in place. Some good practices conducted by firms when reviewing client trading are:

- Announcement alerts received from the London Stock Exchange. The firm then sifts out the pre-planned announcements and focuses on the 'unexpected' announcements. The firm then reviews trading in the stock from the day before the announcement in order to identify particularly timely trades.

- The monitoring of the top five risers/fallers each day over a three day period just prior to an announcement. Timely trades are then flagged for further scrutiny.
- IT systems which flag unusually large transactions and stocks bought and sold in a short period.

Once alerted to a ‘suspicious’ trade, it appears that most firms typically look for any unusual patterns of trading by an account, for instance history of trading and amount of consideration.

We published some Q&As on Suspicious Transaction Reports in our December 2005 issue of Market Watch (www.fsa.gov.uk/pubs/newsletters/mw_newsletter14.pdf).

Research

Although this is not an area we concentrated on in any depth, we did ask the firms for their views on the new research requirements.

The firms that conduct and publish research found this area difficult to interpret because of the new categories of research where a firm needs to differentiate between ‘fact’ and ‘opinion’ (COB 7.17.7R). One firm had decided to cease sending out third party research and has stopped sending circulars, including buy/sell notes. In all other instances research is signed off by Compliance before it is published.

A number of firms mentioned to us that they would appreciate some further guidance about research. A member of our Policy team will give a presentation at the APCIMS forum and will be available for questions. We will also consider another article on research for a future Market Watch.

Training

Training provided to staff varied significantly across the range of firms visited. In two instances it was disappointing to see that firms had not conducted any training on the Market Abuse Directive (MAD). This leaves the firm exposed to breaching the requirements of MAD and could mean that its staff are not properly equipped to identify Suspicious Trades and report these as required to us.

Seven firms had provided some refresher training as described in the bullet points below. In four instances firms had already provided – or were in the process of providing – web-based training to staff. These training packages include a system to enable Compliance to track which staff had undertaken the training and attained the required pass mark. Firms used web-based training packages provided by: Complinet, Emarkets and Fuel. One firm had invited a law firm to provide training to its staff. In most cases, firms focused the training on the new requirements, eg staff were trained how to submit Suspicious Transaction Reports.

Some of the good practice identified from paper-based training some firms have given included:

- a short guide to the Market Abuse Directive on the front page of the firm’s intranet;
- laminate cards outlining signs of insider dealing, market manipulation and transactions intended to mislead the market;
- a one-page summary of the Market Abuse Directive highlighting possible signals of insider dealing and market manipulation;
- circulation of relevant copies of Market Watch, which staff have to sign off to confirm that they have read it;
- ad hoc emails sent to staff reminding them of their obligation to report suspicious transactions; and
- examples of suspicious transactions provided by APCIMS circulated to staff as case studies.

PA Dealing

Most firms run retrospective checks on PA Dealing, looking out particularly for dealing ahead of research, front running and dealing in house stocks. For both trading on the firm's account or for PA dealing activity, most firms were more concerned about insider dealing than market manipulation as they thought the latter was less likely to occur.

Some good practices for PA dealing we noted were:

- Trading not allowed by analysts until seven to ten days after research is published.
- Staff required to hold stock for a minimum of one month.
- Staff required to sign a form confirming that they do not have any inside information.
- Funds for stock needs to be provided up front.
- No short selling is allowed.
- Written permission from the CEO or compliance manager is required when trading in house stocks and dealing is not allowed because the firm holds principal positions.
- A blanket ban for corporate finance staff on trading in house stocks.
- PA trading conducted in batch sessions (three times a day), therefore reducing the risk of front running.

Telephone recording/mobile phones

It is very positive to note that all the firms we visited have telephone recording systems in place, with eight out of the 13 firms taping all telephone lines (the remainder taping dealing lines only).

All firms keep tapes for a minimum of one year.

Some firms did ad hoc checks of taped telephone lines as part of their compliance monitoring.

Policy on the use of mobile phones varied from firm to firm. Most firms do not allow mobile phones to be used on the dealing floor, however, some firms only stipulate that orders need to be placed on a taped line. Firms should consider carefully their policy in this area.

Corporate and private clients/dissemination/watch lists/Insider Lists

Only five of the firms we visited had corporate clients. A good practice area identified was where firms provide advice to corporate clients on the content of announcements before their release. One firm in particular confirmed that it had ended a client relationship as the client had not informed it of an announcement, as is required contractually. In addition, this firm is also considering insisting that the client's corporate director sign-off on the accuracy of information contained in announcements.

- All firms that conduct corporate finance work confirmed that the corporate financiers are segregated from the rest of the firm by Chinese walls. Typically, watchlists are monitored/altered by Compliance when it receives instructions from corporate finance.
- One firm noted that it keeps an insider list for all companies it acts for (both officially listed and AIM) as per the Disclosure rules.
- Another firm visited maintains two lists, one which contains information on companies in close periods and the second list which contains details on 'work in progress' at companies, for example, a fundraising.

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- One firm has a form entitled an Insider Declaration Form (IDF). Staff who come into contact with inside information must complete the IDF and send it to Compliance.
 - Another firm stated that once a company appears on the watchlist, Compliance checks all transactions in that stock from the previous day to establish who dealt and whether there are any connections between the person dealing and the company.

Contact details

This newsletter is produced periodically by the Market Conduct team in the FSA's Markets Division. Previous copies, and other relevant material, are available on the dedicated webpage: www.fsa.gov.uk/marketconduct. If you would like to receive this newsletter by email, or have any comments on it, please contact market.watch@fsa.gov.uk.

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