

Market Watch



FSA®

Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues

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Introduction

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

Alpha Capture Systems

Traditionally, trading ideas and strategies have been communicated by investment banks, amongst others, to their clients by telephone or face-to-face by a firm's sales force. But there is an increasing move to communicate ideas through an electronic 'Alpha Capture System'. Such systems allow firms to submit trading ideas to a client in a written electronic format with an accompanying rationale, timeframe and conviction level. These systems typically give the recipient a systematic way to quantify and monitor the performance of different ideas. This can help them decide which ideas to take forward and how to distribute commission.

We have completed a series of meetings with providers of Alpha Capture systems and with several investment banks who input ideas to these systems. The aim was to increase our understanding of how such systems work. We discussed the controls that those inputting and those receiving ideas have put in place to ensure that ideas do not include inside information or other relevant information not generally available.

As with all forms of client communication, there is a risk that those inputting ideas may seek to pass on inside information or relevant information not generally available to clients. We recognise that the clear audit trails generated by Alpha Capture systems suggest the risk of this being done explicitly might be lower than through traditional communication methods. However there remains a risk that those inputting ideas may still do so on the basis of inside information, masking this by giving another seemingly plausible rationale.

Examples of good practice that we observed during our visits included firms taking measures such as:

- Referencing Alpha Capture systems in their current policies and procedures or satisfying themselves that their current policies and procedures cover the submission of trading ideas via this medium.
- Training in relation to client communications includes discussion of Alpha Capture Systems.
- Performing risk-based monitoring of the trading ideas submitted to these systems, and challenging the rationales, especially those that were submitted shortly before significant Regulatory News Service announcements.
- Producing automatic, system-generated compliance alerts when an idea is submitted that involves a security on the firm's restricted list or watch list. In addition, generating an automatic alert when the conviction level or investment size of an idea already submitted is adjusted following a stock moving to the firm's restrict list or watch list.

This is not FSA guidance.

- Compliance departments using the clear audit trail provided by Alpha Capture systems to test whether employees are following compliance guidance and procedures. Examples may include: ensuring written communication policies are followed, and checking clearance procedures have been followed for ideas submitted in securities that are subject to in-house research.
- The, occasional, submission of ‘rogue’ ideas into the system to see if this is correctly detected by the business as being a breach of procedures and escalated correctly according to the firms’ policy (e.g. escalation to Compliance). Most firms noted that there was a daily report of all ideas submitted to the system that should be reviewed by the business.

We are aware that some firms may be developing their own in-house Alpha Capture system, or considering changes to their use of such systems. We would be happy for such firms to contact us directly, or via their supervisor, if they would like to discuss any system and controls issues and we will continue to keep a watching brief on the use of these systems within the industry. Please contact either Simon Dixon or Ruth Gevers.

‘Spring-Loading’ and ‘Bullet-Dodging’

Several recent articles in the press have discussed option-granting processes. Some of the articles have focused on concepts such as ‘spring-loading’ and ‘bullet-dodging’. ‘Spring-loading’ is when a company brings forward the timing of its option grants to office holders of the company so these same office holders can benefit from an anticipated rise in the share price once an impending positive announcement is made. ‘Bullet-dodging’ involves delaying the timing of an option grant so a company’s office holder can benefit from having the options priced after an anticipated fall in the share price once an impending negative announcement is released.

Whether the practices of spring loading and bullet dodging amount to market abuse under the Financial Services and Markets Act (FSMA) will depend on the facts of each case. But, in any event, the acquiring or granting of options would amount to ‘dealing’ under FSMA s.118(2). ‘Dealing’ is defined as acquiring or disposing of (including agreeing to acquire or dispose of) an investment and an ‘investment’ includes options (see s.30A, s. 22 and paragraph 17 of Schedule 2 of FSMA).

So, if an employee, being an insider, acquires options on the basis of inside information, then they may be committing market abuse. Similarly, the person granting the option may well be committing market abuse. S.118(3) (improper disclosure) may apply where, for example, a director is aware of an impending announcement and discloses that information to the person responsible for granting options in order to influence the timing of the grant of options. S.118(4) (misuse of information) would also be applicable where the information is not inside information but is, nevertheless, relevant information not generally available to those using the market.

Any decision by a company to give clearance for dealings during the run up to the release of inside information would be a breach of the Model Code. Any attempt to delaying the announcement of the dealing date would be a breach of Company Law and the Disclosure Rules as directors are required to notify dealings to the company within a few business days. Furthermore any decision by a company to announce awards in an open period but back date the price would be a breach of LR9.4.4 which prohibits the granting of options at below market price without prior shareholder approval.

Transaction Reporting System (TRS)

Since mid November 2005, firms sending us transaction reports – which we require under our rules in SUP17 – via our Direct Reporting System (DRS) have been migrating over to our new Transaction

Reporting System (TRS). We would like to thank those who have completed the migration, and those who are in the process of migrating, for your continued efforts and cooperation.

We would also like to take this opportunity to remind firms using TRS that the TRS data reference guide and the TRS online help text will help you to ensure that your transaction reports pass the validation in TRS. However, to ensure that each transaction report complies with transaction reporting rules you will need to consult SUP17 (link: <http://fsahandbook.info/FSA/html/handbook/SUP/17>). Our Transaction Monitoring Unit is happy to give firms a sample of reports we have received so they can check those reports against their own internal records (please contact TMU via email at tmu@fsa.gov.uk).

Most firms who were using DRS are now using TRS. We continue to receive very positive feedback about the new system and feel confident that it is a welcome improvement upon DRS.

FROM 1 OCTOBER 2006 DRS WILL NO LONGER BE AVAILABLE FOR USE. We have written to those firms who have not yet completed their migration to remind them they must do this before then.

If you have any feedback on TRS, or any queries about migrating to it, please do not hesitate to contact Jo Grant-Wilson in our Transaction Monitoring Unit. Please email jo.grant-wilson@fsa.gov.uk or ring her on 020 7066 2870.

Transaction reporting of credit default swaps

With the ever-increasing activity in the credit markets we would like to encourage firms to report as much detail as possible when they report single name credit default swap (CDS) transactions to us.

What should the report include?

The report should include the following data:

trade date, time, buy/sell, counterparty, reference entity, the nominal size, currency, price (ie. spread at which the trade was executed, in basis points), the term and the type of restructuring involved in the contract e.g. MMR.

Where possible, the product description field should contain the reference entity (name and restructuring terms), the size field should contain the nominal size of the transaction, the price field should contain the spread at which the transaction was executed, in basis points, the derivative type should be 'Swap' and the settlement date field should contain the maturity date of the contract.

We appreciate that not all permitted reporting systems are the same and some may not be able to apply this format. In such cases, please add the required data to the description field.

Why are we making this request?

Reporting transactions in this format will greatly reduce the number of requests for information that we make of firms. This will reduce the resources that firms need to dedicate to those enquiries.

Here is an example of the type of transaction report we would prefer to receive:

Date	Time	Product	B/S	Quantity	Currency	Price	Counterparty	Settlement Date
15-08-2006	11:29	XYZ Corp CDS MMR	B	10,000,000	GBP	348	ABC Bank	Sep-2011

Please note that in our Consultation Paper CP06/14 – ‘Implementing MiFID for Firms and Markets’ – we proposed introducing a separate instrument classification for credit derivatives to further enhance our ability to monitor this growing market.

If firms have any questions about reporting CDS, they should contact Mark Edmonds or Gary Brook (Market Conduct), or the Transaction Monitoring Unit via email at tmu@fsa.gov.uk.

Markets in Financial Instruments Directive (MiFID) – what this means for transaction reporting

On 31 July, we published the MiFID Consultation Paper (CP06/14, available via the following link: http://www.fsa.gov.uk/pubs/cp/cp06_14.pdf). The MiFID rules will require a replacement of the existing Transaction Reporting Rules contained within SUP17 of the FSA Handbook. So, here we outline the main proposals within the CP.

What will it introduce?

MiFID will introduce a uniform standard for transaction reporting across all categories of MiFID investment firms. The MiFID transaction reporting requirements cover much of the same ground as our existing requirements and deal with four main issues: the definition of a reportable transaction; the means of making a transaction report; the content of a transaction report; and the competent authority to which each firm must report.

MiFID will require a transaction report for transactions in any financial instruments admitted to trading on a regulated market. This will extend the transaction reporting obligation to transactions in commodity, interest rate and foreign exchange derivatives admitted to trading on a regulated market. MiFID sets out 23 mandatory fields for the transaction report which in most – if not all cases – firms will submit to us through an Approved Reporting Mechanism, which is discussed further below. MiFID also requires host state reporting, as opposed to the current home state reporting arrangements.

What else is the FSA proposing?

In addition to the proposals above, we intend to retain our existing rules requiring transactions conducted on prescribed markets and in certain OTC derivatives (eg CFDs, spreadbets and some credit default swaps) to be reported to us. We also intend to introduce some new provisions going beyond MiFID in some areas, including requiring firms to identify in their report those principal transactions done for the house account and those done for client facilitation.

What about Approved Reporting Mechanisms?

We have outlined our proposals in this area in a draft paper to external stakeholders and selected trade bodies. These proposals stem from our informal consultations with external stakeholders on the requirements, approval process for and monitoring of Approved Reporting Mechanisms (ARMs). An ARM is the method through which most, if not all firms will submit reportable transactions to us after MiFID comes into force next year.

We are keen to progress these discussions and our proposals as we believe finalising the rules/requirements applying to ARMs will provide significant assistance to firms planning for the introduction of the new MiFID-driven transaction reporting requirements.

For a copy of the draft ARMs paper, please contact Sujitra Krishnanandan of the Transaction Monitoring Unit on 020 7066 7920 (email: sujitra.krishnanandan@fsa.gov.uk).

Thematic Review of Anti-Market Abuse systems and controls

In the February 2006 edition of Market Watch, we provided feedback on our Market Monitoring Department's review of retail brokers' anti-market-abuse systems and controls.

Here, we report on the findings of two further FSA studies – one conducted by our Wholesale Banks Department and the other by our Wholesale Investment Firms Department in 2006. Each study took a sample of ten firms¹.

Overall Findings

Most firms were well briefed and had a good overall awareness of the particular market abuse issues affecting them. Some had completed detailed mapping exercises of the joint Treasury and FSA implementation document or appointed external consultants to help with their preparations. Others relied on internal resources to develop procedures and provide briefings to staff and senior management.

We came across a number of good practices, but, in contrast to a number of thematic reviews, this was not always a reflection of the size of the firm. Specifically, a number of the 'good' examples came from the smaller firms, who were able to demonstrate sound anti-market-abuse controls. There were also some disappointing results and a handful of firms were ill prepared – offering staff little or no awareness training. More surprising was that, although aware of the relevant issues, some firms did not consider that market abuse applied specifically to them because of their business models, while other firms in the same sector were more able to highlight the issues and how they affected their business.

Also, although most firms had 'know your customer' and front-running monitoring procedures in place, few identified these as tools for identifying potential suspicious transactions or instances of market abuse. Our study also indicated that some corporate finance firms may need to revisit their disclosure procedures to ensure they meet the enhanced requirements for maintaining insider lists when acting for issuer clients.

Compliance Controls and Monitoring

In the main, firms' anti-market abuse systems and controls were maintained and overseen by the compliance department. It was encouraging to note that all appeared to have adequate escalation processes to ensure that senior management and/or the FSA were alerted to any actual or potential breaches. Transaction monitoring was mainly conducted manually, with the focus being on the front office to identify suspicious transactions. Few firms had introduced a centralised transaction monitoring unit to help meet the additional suspicious transaction reporting requirement brought in by the Market Abuse Directive (MAD).

Another positive sign was that those firms with corporate finance and research departments that did have access to market sensitive information generally had strong policies about Chinese walls, coupled with automated means of monitoring proprietary/house trading against restricted lists. It was also encouraging that a handful of those firms intend to install or enhance an automated system for monitoring these transactions. However, there is still room for firms to improve their proactive monitoring for misuse of inside information.

¹ WBD included six trading and investment firms, three asset managers and one wholesale bank. WIFD included two hedge funds, five brokers (of which one was an online broker), two corporate finance firms and one custody bank.

Suspicious Transaction Reporting (STRs)

A point of interest is that very few firms had submitted Suspicious Transaction Reports since the formal STR regime was introduced when MAD was implemented last year. This could be the result of us urging firms to opt for quality rather than quantity when submitting STRs, or it could also be an indication that monitoring tools need to be enhanced at firms. The Market Monitoring Department is currently undertaking a further thematic study on this.

Personal Account (PA) Dealing

PA dealing procedures was another area where practices were wide-ranging. PA monitoring ranked highly on the list of tools firms used to monitor and detect potential market abuse however, the most sophisticated procedures were not necessarily observed at the larger banks or those that had access to restricted information. Most firms required pre-approval for personal account dealing, using restricted lists to monitor before and after trading. Some firms had arrangements with brokers to provide copies of contract notes straight to the compliance department. Speculative trading was actively discouraged by other firms and minimum holding periods put in place to prevent this, while two firms did not allow PA dealing at all.

Staff Training

Perhaps one of the areas of most disappointment was in the quality of staff training across the sample of firms. Unacceptably, five of the 20 firms had no specific training in place. However, some firms demonstrated good examples of varied and robust training such as the use of case studies and live examples to reinforce learning, or automated computer-based packages to test staff's knowledge and awareness. There were also plans to introduce periodic refresher training courses to address many specific areas of weakness.

This was an issue that we also highlighted from our review of retail firms and is thus an area that we would strongly encourage all firms to review. We note that firms should expect Supervisory teams to cover this during on-site ARROW assessments or other meetings.

Inside Information

Where inside or restricted information was an issue, we observed that all but two firms (where significant weaknesses were identified) viewed this as a key risk area and, as a result, developed their systems to attempt to control the flow of inside information in proprietary trading areas. However, as far as client trading activity was concerned, firms tended to monitor for instances of misuse of information after the event rather than proactively restricting the flow of sensitive information in client trading areas.

Also, although firms monitored compliance with the best execution rules and, for example, had processes in place to post monitor front running/piggy-backing, there is room for these procedures to be made more proactive. Few firms even identified these as tools for specifically preventing market abuse or identifying suspicious transactions. We also identified other areas which gave us cause for concern, namely where proprietary trading and client brokerage desks were situated on the same floor in close proximity.

Investment Research

Only four firms in the sample produced and/or disseminated investment research, and most seemed to have a good grasp of the disclosure requirements introduced by MAD with relevant controls having been developed. Given our heavy focus in this area in previous years we were pleased that we did not identify any particular weaknesses with procedures in this area.

Disclosure Rules

The sample produced five firms that received inside information when acting for corporate clients. Our discussions with these firms left us uncertain about the extent of the knowledge some had of the disclosure rules in this area. Firms undertaking such activities must ensure that they are familiar, and compliant, with the relevant rules regarding the maintenance of insider lists of employees with access to inside information. Few firms were sufficiently prepared either for the enhanced requirements to maintain specific insider lists on behalf of issuer clients or the additional transaction disclosure requirements for persons discharging managerial responsibilities.

Stabilisation and Buy-Backs

This was not an area where we observed that firms were particularly active. We held discussions with two of the firms visited who have been involved in buy-back programmes and stabilisation, where it was notable that they had adopted different approaches to use of the safe harbours. On balance, it appears that these firms are aware of the apparent risks of undertaking abusive behaviour and appear to seek comfort from the adequacy of their systems and controls to monitor these activities.

Contact details

This newsletter is produced periodically by the Market Conduct team in our 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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