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Financial Services

Providing Strategic Legal Guidance to the Global Financial Services Industry

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UK Financial Services Update

FCA Launches Industry Consultations on Enforcement Approach and Best Practices for Detecting and Preventing Financial Crime

FCA launches consultations on: (i) its Approach to Enforcement; and (ii) updating its Financial Crime Guide to address insider dealing and market manipulation

INTRODUCTION

The UK Financial Conduct Authority (FCA) has recently launched two consultations that will be of interest to financial services clients. These publications are noteworthy because they outline the FCA's approach to enforcement, consolidate and augment the FCA's guidance on best practices for detecting and preventing financial crime, and offer market participants an opportunity to comment on both topics. Members of the financial services industry subject to the FCA's jurisdiction should evaluate how their current internal controls compare to the FCA's guidance, and should consider taking advantage of this opportunity to actively participate in both consultations.

1. As part of a series of papers from the regulator published under the banner of "Our Mission", the FCA has published *Our Approach to Enforcement* and is seeking industry feedback on the document by 21 June 2018; and
2. the FCA has also published *Guidance Consultation GC18/1* with proposed new guidance on good (and bad) market practice it has observed regarding firms' systems and controls for detecting, reporting and countering the risk of insider dealing and market manipulation. Feedback on this consultation is due by 28 June 2018.

OUR APPROACH TO ENFORCEMENT

This relatively short paper (16 pages) seeks to outline the regulator's approach to enforcement and how this approach is aligned with its strategic and operational objectives and its overall Mission. The paper is divided into five chapters: (1) Our role in enforcement; (2) How we identify harm; (3) Diagnosing harm through our investigations; (4) Sanctions and remedies available to us; and (5) Evaluating our approach to enforcement and measuring our performance.

Key themes arising from *Our Approach to Enforcement* include:

- The FCA has started a review of its Penalties Policy (as currently set out in the Decision Procedures and Penalties Manual (DEPP[1]), and intends to publish a consultation paper about this review later in 2018. It has also started work on a full review of the Enforcement Guide (EG[2]) and aims to publish a consultation paper in 2019.
- The overriding principle guiding its approach to enforcement is *"a commitment to achieve fair and just outcomes in response to misconduct", noting that "[m]arket integrity and consumer confidence is stronger when misconduct is identified and dealt with quickly and fairly through legal processes."*
- The FCA is seeking to maximize its responsiveness and efficiency, which means not only pursuing cases aggressively where the evidence proves serious misconduct, but also discontinuing investigations quickly where there is no evidential case to answer. Where it takes action the FCA will use the full range of deterrent and remedial powers at its disposal to *"put things right"*, including financial penalties, prohibitions, public or private censures, variations of permissions, suspension or restriction orders, redress and/or remedial/restorative measures.
- UK financial services firms are already subject to extensive obligations to self-disclose and remediate significant failings in their systems and controls. However, the paper states that the FCA will seek to further encourage firms to voluntarily account for and redress misconduct – it will do this by imposing more lenient sanctions on firms that do this, while imposing more severe sanctions on firms that do not.
  - The paper states that *"Firms and individuals should not wait for an investigation to end before acting in a way they think is right. We encourage firms and individuals to examine their own affairs and, where appropriate, take their own remedial action …. Firms that take action to address harm caused by serious misconduct demonstrate integrity."* It is noted that even where misconduct has clearly occurred and harm has been suffered, if a firm or individual fully accounts for it and puts things right there may be circumstances (in *"extraordinary cases"*) where the regulator decides that no enforcement sanction is required at all.
- The FCA is taking steps to maximize its ability to detect misconduct at an early stage – by harnessing intelligence and data gathered through its Market Oversight, Supervision, Authorisation and Competition Divisions, and via its financial crime, intelligence and whistleblowing teams. It also works in an increasingly close and collaborative way with other domestic and international regulators and law enforcement authorities.
- The FCA will carry out investigations into both firms and individuals where it appears that those individuals may be involved in a suspected breach – and these investigations will usually be conducted at the same time, especially where the individuals have had a senior management or governance role in the events under investigation. By taking a strategic approach to investigations, the FCA will seek to quickly identify the *"heart of the case"* and the key evidence so that it can make a timely decision whether to continue, or discontinue, the investigation.
- In addition to its extensive civil/regulatory enforcement powers, the FCA can and will use its criminal powers to prosecute firms and individuals who commit financial crime (such as insider dealing or market manipulation) or who undertake regulated activities without authorisation.

- The FCA carries out an annual assessment of its investigation/enforcement activity (published every year in its Enforcement Annual Performance Account). Moreover, during and at the end of every investigation (no matter what the outcome) the FCA will seek feedback from firms and individuals in order to continually improve its processes.
- The paper concludes by asking whether it has set out the FCA's approach to enforcement clearly and, if not, what more could the FCA do to explain or clarify its approach. As noted above, feedback on the paper is due by 21 June 2018.

In our view, the paper is largely consistent with how the FCA is now conducting enforcement investigations in practice. Since Mark Steward became the Director of Enforcement in September 2015, there has been a noticeable change of approach alongside a significant uptick in the volume of investigations. In addition, Mr Steward's arrival triggered a new framework for the enforcement and settlement process, which has been in effect since 1 March 2017, as well as an enhanced internal governance structure.

However, this ambitious approach towards investigations has put pressure on the FCA's resources, making it difficult for the regulator to consistently achieve its stated aims of efficiency and speed. Cases can still languish due to lack of attention, notwithstanding the best efforts of counsel to move the matter to an appropriate conclusion.

The paper's commentary on international cooperation and collaboration are definitely borne out in practice. We are aware of an increasing number of cross-Atlantic secondments between US and UK financial regulators and law enforcement authorities, and it is now assumed that US and UK investigators are in constant contact with each other about prospective and ongoing matters. In addition, we are seeing evidence that the FCA is serious about using its criminal investigation and enforcement powers on a more regular basis, particular in the areas of anti-money laundering (AML) and insider dealing/market manipulation.

CONSULTATION ON PROPOSED GUIDANCE ON FINANCIAL CRIME SYSTEMS AND CONTROLS: INSIDER DEALING AND MARKET MANIPULATION

The FCA's Financial Crime Guide (FCG) is a useful repository of the regulator's consolidated guidance on steps that firms of all sizes can take to identify and counteract financial crime. Its contents are derived primarily from thematic review exercises undertaken by the FCA, and while it does not form part of the FCA Handbook, it contains guidance on relevant Handbook rules and principles.

The existing version of the FCG addresses the FCA's general expectations around financial crime systems and controls, and has specific guidance regarding: (i) Money Laundering and Terrorist Financing; (ii) Fraud; (iii) Data Security; (iv) Bribery & Corruption; and (v) Sanctions and Asset Freezes. In addition to making minor amendments (to track recent regulatory changes) and some formatting changes, the consultation introduces a proposed new chapter addressing Insider Dealing and Market Manipulation.

In the UK insider dealing is a criminal offence under section 52 of the Criminal Justice Act 1993. In addition, sections 89-91 of the Financial Services Act 2012 identify a range of behaviours which amount to criminal market manipulation offences. Moreover, since 3 July 2016 the EU Market Abuse Regulation (MAR) has been in force. MAR has direct effect in the UK and sets out the civil offences of market abuse. Given that criminal offences for insider dealing and market manipulation already exist in the UK, it chose not to opt in to a related EU directive on criminal sanctions for insider dealing and market manipulation (CSMAD).

The proposed new chapter sets out four "themes" for how firms should go about countering the risk of being used for the purposes of insider dealing and market manipulation. These themes are: (1) Governance;
(2) Risk Assessment; (3) Policies and Procedures; and (4) Ongoing Monitoring. The specific examples of good (and

poor) practice identified by the FCA can be found in the consultation paper. However, we comment briefly on each theme below.

Governance

As with all areas of financial crime risk management, the FCA expects a firm's senior management to take real responsibility for the firm's systems and controls in relation to insider dealing and market manipulation (whether in the context of employee, or client, trading activity). A firm must be able to demonstrate that senior management understand what insider dealing and market manipulation is, and all of the ways that the firm might be exposed to such offences. Firms should also ensure that senior management are provided with adequate, regular management information in relation to suspected insider dealing and market manipulation, so that they are in a position to take action and set an appropriate "tone from the top." Other areas of focus in this section of the consultation paper include the role/responsibilities of the Money Laundering Reporting Officer (MLRO) and his/her interaction with those carrying out order and trade surveillance/monitoring, as well as what steps senior management should take to ensure that staff have appropriate training to identify suspicious trades and behaviours.

Risk Assessment

Firms are expected to actively assess (and regularly review) the risk that they may be used to facilitate insider dealing or market manipulation – by reference to the types of clients serviced and the specific products, instruments and services offered/provided by the firm. This exercise (and the decisions which flow from it) should be carefully documented, and it should be revisited at regular intervals and/or upon the occurrence of a breach or failure. The firm's insider dealing/market manipulation risk assessment should also be aligned with its AML risk assessment, and should drive its risk management and mitigation efforts in this area, which may include: (i) undertaking enhanced order and transaction monitoring on clients; (ii) setting client-specific pre-trade limits; and/or (iii) ultimately declining business or terminating client relationships.

Policies and Procedures

It is important that a firm's policies and procedures should be aligned, and make reference, to the firm's risk assessment exercise (as discussed above). In addition, they should aim to both (i) identify and prevent attempted financial crime before any trade is executed; and (ii) mitigate future risks posed by clients that have been identified with suspicious trading behaviour. Amongst other things, escalation procedures and whistleblowing arrangements should play a role in this.

It is noted that policies and procedures must reflect the FCA's expectation that market participants should refuse to execute any trade where there is a clear risk that the trade is in breach of relevant legal or regulatory requirements, and that specific provisions relevant to each business area (including front office functions) should be communicated and embedded.

Ongoing Monitoring

This section of the consultation paper addresses the FCA's expectations around client and transaction monitoring (as well as overlapping obligations imposed by MAR). It also sets out steps that firms should consider taking when suspicions of insider trading or market manipulation arise, including:

- complying with obligations to report the suspicions via a Suspicious Transaction and Order Report (STOR) to the FCA and/or Suspicious Activity Report (SAR) to the National Crime Agency (NCA);
- carrying out enhanced due diligence and enhanced monitoring of the client's trading activity (including applying enhanced scrutiny to incoming orders, prior to execution);

- restricting the client's access to particular markets or instruments, or restricting services provided to the client (e.g. direct market access) and/or the amount of leverage the firm is willing to provide to the client; and/or
- ultimately terminating the client relationship (which may also be an event which requires the firm to make a proactive notification to the regulator).

As noted above, any feedback on the proposed guidance is due by 28 June 2018.

[1] www.handbook.fca.org.uk/handbook/DEPP
[2] www.handbook.fca.org.uk/handbook/EG