EYE ON THE MARKETS

OUR GLOBAL NEWSLETTER FOCUSING ON REGULATION FOR TRADING MARKETS

October 2015

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GLOBAL ENFORCEMENT TRENDS FOR 2015

TRANSACTION REPORTING FOR ALL: THE NEW NORM

Kinetic Partners

A Division of DUFF & PHELPS

WELCOME

Welcome to Duff & Phelps' Kinetic Partners division's second edition of Eye on the Markets, our global newsletter focusing on regulation for trading markets.

The regulatory landscape continues to evolve and regulators across the globe, particularly the SEC, SFC and FCA, have confirmed that they will focus their attention on market misconduct, thereby not easing the pressure on firms and individuals.

In this edition, we would like to share with you some lessons learned from our recent discussions with the industry. A number of recent high profile cases across the globe against firms and individuals relating to hacking and insider dealing, high frequency trading and spoofing for example show us that the regulators are not asleep at the wheel, and will act collaboratively across markets to stop wrongdoers. The political climate blows in their favour and clean and orderly markets are what we all strive for. As a certainty, cultural change plays a strong part of our new world of regulation.

We have also sought to be practical and forward thinking in this newsletter as we are all starting to look ahead at MiFID II and MAD II that will drive fundamental changes in the coming months. These key regulations should be taken seriously by firms not only in Europe but also on a global scale. We are thankful to our guest writer, Joanna Williams from Reed Smith who is an expert in an area quite new to us all, namely REMIT and who gives us useful information and guidance on this topic.

I hope that you are able to take away some valuable insight from the articles and look forward to any feedback you may have.

Kind regards,

Monique Melis
Managing Director
Global Head of Regulatory Consulting

GLOBAL ENFORCEMENT TRENDS FOR 2015

By: Monique Melis

We recently published our annual Global Enforcement Review 2015 which explores enforcement trends at key regulators in Europe, the US and Asia. Our analysis shows a picture of financial services regulators that are leaner, but more vigorous. Their smart, targeted approach to penalising poor practice and misconduct will require a similar response from the industry.

Spending increases among the regulators appear to be moderated or reversed this year. Indeed, the FCA cut spending by 17% in the UK while a spending growth at the US Securities and Exchange Commission (SEC) was down to 8%. In Hong Kong, the Securities and Futures Commission (SFC) reduced its spending by more than half from 31% in 2013 to 13% in 2014.

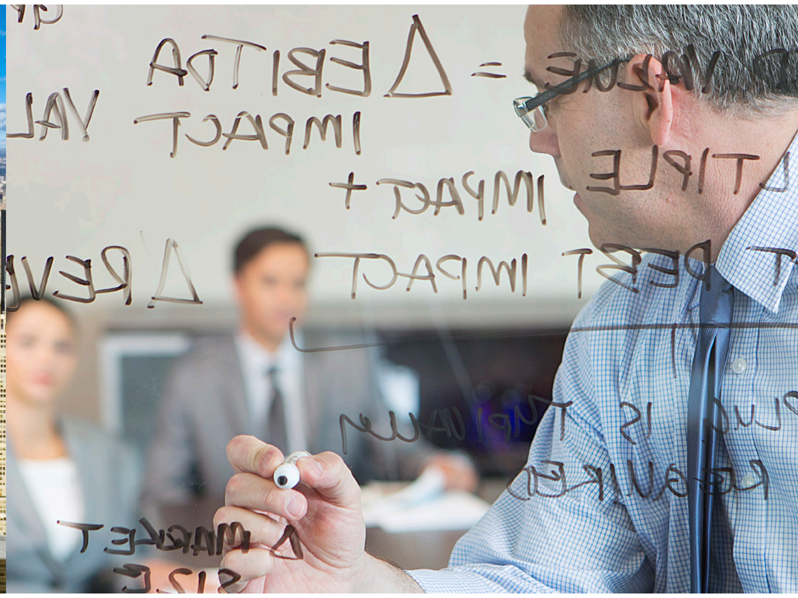
Although it points to a slowdown in spending from 2013 to 2014, there has been a spike in the size of financial penalties, with particularly big increases in the average size of fines from 2013 to 2014: 272% increase at the FCA, 146% increase at the Financial Industry Regulatory Authority (FINRA), 135% increase at the US Commodity Futures Trading Commission (CFTC) and 50% increase at the SFC. Even more striking, from 2009 to 2014, the average financial penalty grew by 1815% at the FCA, 772% at the CFTC and 50% at the SEC.

The averages are clearly impacted by a relatively small number of big penalties (namely Libor and FX rate manipulation), but they are still representative of the trend towards more serious punishments for wrongdoing. New enforcement actions relating to such high-profile scandals will continue to be felt in future years.

The industry must be wary, however, of the danger of firms “budgeting” for such massive fines and ultimately passing the costs onto shareholders and consumers. If this happens, the entire point of delivering severe sanctions will be lost.

Fewer, tougher enforcement actions

The increase in average fine values, however, has not in every case equated to an increasing numbers of cases in 2014. Analysis shows that the number of enforcement actions grew only at the SEC (by about 10%); the FCA, CFTC and FINRA all saw a decline in the number of cases filed.



Combined with the rising level of fines, regulators seem to be concentrating on a small number of cases that are pursued aggressively to encourage the rest of the industry to comply. The evidence also suggests that regulators are particularly focused on cases of market integrity and consumer protection, although priorities vary by jurisdiction.

Whether spending growth accelerates again in coming years or not, however, our report also highlights two other trends are central to the regulators' approach:

Increasing reliance on technology
With more and more trading being done electronically, regulatory attention continues to shift towards solutions that monitor vast numbers of transactions and data. This responsibility will be shared with the industry itself, as technological developments create both opportunities for firms, and greater expectations of them.

Holding individuals accountable
Regulators see this as a powerful deterrent, though their success in this respect is mixed. Actions against individuals accounted for a substantial portion of SEC and CFTC cases, but at the FCA the figure was notably low.

Over the next couple of years we expect an increase in M&A as companies seek to take advantage of weakness in the sector. In the current climate it is vital that businesses and owners take advice early to help maximise the number of options available.

Recommendations

It is dangerous to put too much weight on the findings from a single year, particularly given the difference between regulators and geographies. However, enough of a consistent regulatory approach can be discerned for some suggestions as to how the most successful firms will respond:

Invest in compliance and controls
Nine-figure and $1 billion+ fines and settlements remain rare, but they are not the aberration of a single year. Despite the risk of costs being passed to shareholders and a desire to hold individuals to account, prohibitively high fines are now a settled feature of the market. Investments in controls must increasingly reflect this, particularly around market abuse and consumer protection, but also taking into account regulators' priorities in different regions.

Invest in technology
Investments in technology will continue to play a key role for both regulators and firms. Increasing numbers of suspicious transaction reports suggest firms' capabilities are increasing, but so too are regulators' expectations of how firms are monitoring themselves. As technology develops and resources become more limited, regulators cannot expect to keep up with developments in the marketplace. The reliance on the industry to police the market is only likely to grow.

Invest in people
As regulators increasingly focus on actions against individuals, they risk undermining the ability of firms to recruit appropriately skilled staff to fill key positions in the control framework. Compliance, internal audit and other control functions are valued highly, and firms need to continue to nurture internal talent in these areas. They must also ensure that responsibilities imposed by regulators reflect the organisational reality. In that sense, it is the duty of the Board to effect the institutional and cultural changes needed to support these functions in meeting compliance obligations.

For more information, please contact **Monique Melis,** Managing Director and Global Head of Regulatory Consulting.

TRANSACTION REPORTING FOR ALL: THE NEW NORM

The tsunami of regulatory change continues to hit firms and alter the landscape within which they operate.

The FCA's Transaction Monitoring Unit revised its Transaction Reporting User Pack on 6 February 2015 and gave firms 6 months to implement relevant changes in order to comply with new reporting requirements. TRUP Version 3.1, as it is referred to, became effective from 6 August 2015.

Most firms are busy preparing for MiFID2/R implementation on 3 January 2017 and have project teams in place. However, this should not distract them from continuing to ensure existing reporting under MiFID remains accurate and complete. It is a challenging time for Operations, IT, and Compliance as it requires them to focus on future proofing their business while dealing with Business as Usual (BAU) issues.

The FCA does not appear to be taking its foot off the peddle in taking action against firms who continuously or repeatedly fail to report transaction reports accurately or fail to report at all.

The FCA fined Merrill Lynch International in April 2015 £13,285,900 for inaccurately reporting over 35 million transactions and failing to report approximately 121,000 transactions. The fine was a significant increase from previous fines levied against firms such as Deutsche Bank (£4.7m) and RBS (£5.6m), most notably as the FCA decided to increase its fine per breach from £1to £1.50. Frustrated at the quality of data it is receiving almost 8 years on from MiFID implementation, FCA determined this increase necessary in order to further improve standards of Transaction Reporting.

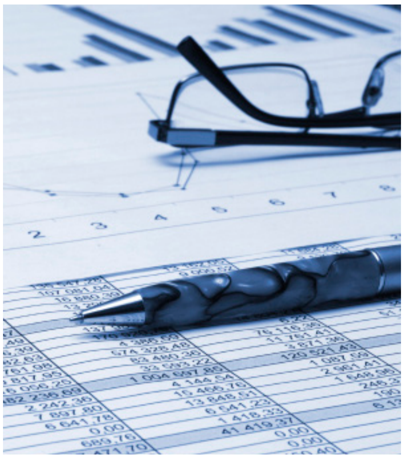
Firms should expect to have their transaction reports scrutinised more and more in the future as the Market Monitoring Team strengthens its group and improves its surveillance tools and techniques. Patrick Spens heads the team and now has over 70 staff comprising of PhD quantitative analysts and former intelligence officers. His savvy entrepreneurs write their own algorithms to detect unusual patterns and potential market abuse.

The accuracy of the data received on transaction reports is integral to the team being able to carry out its monitoring function properly. They will continue to educate firms about the need for sound transaction reporting. Firms must take heed of these headlines and get their house in order to mitigate the likelihood of ending up in the regulator's spotlight.

> Firms should expect to have their transaction reports scrutinised more and more in the future

Portfolio Managers set to transaction report under MiFIR

Buy side firms must recognise that where they rely on the portfolio manager exemption as set out in section 9.7 of FCA's TRUP, there may well be instances in which they cannot rely on the broker to report and will have to report themselves. For example, where the firm deals directly with a non-EEA broker, the broker is not caught by MiFID



Transaction Reporting rules. Under MiFIR, the portfolio manager exemption falls away and is replaced with the concept of transmission of orders which will require managers to (should they wish to adopt this approach):

1. Enter into an explicit reporting agreement with the broker
2. Transmit certain detailed information to the broker within T+1
3. Still remain responsible for the accuracy and completeness of the reported information

Buy side firms need to review their existing architecture in earnest in order to develop robust operational processes, systems and controls in time for MiFIR go-live.

For more information on MiFID and MIFIR, please contact **Zach Johnson** or **Judy Leung.**

ELECTRONIC TRADING: INCREASED REGULATION AND THE NEED TO PREVENT PRICE SPIKES

Firms continue to face many challenges whilst balancing the need for speedy execution against the increasing stringent regulatory requirements to avoid creating excessive market impact.

Since the flash crash in 2010, we have witnessed a stream of market events which have impacted the reputation, profitability and at times the existence of several market participants. This has fuelled the concerns of politicians and regulators alike to the extent that risks associated with automated trading systems could cause a catastrophic markets related event.

Whilst MiFID encouraged competition and led to increased market fragmentation, we can expect a step change under MiFID2 as the number and variety of execution venues will substantially increase. In an attempt to closely monitor and control electronic trading, MiFIR will introduce provisions to ensure that High Frequency Trading (HFT) does not have an adverse effect on market quality or integrity, including:

- Requiring HFT firms, engaging in proprietary trading, to become authorised
- Introducing new systems and control requirements on the use of algorithms
- Requiring HFT firms (who use market making strategies) to enter into market making agreements
- Trading venues will set limits on 'order to trade' ratios
- Minimum tick sizes will be set
- Venue pricing can be used to penalise excessive order messaging

In relation to algorithmic trading systems, MiFIR will introduce a requirement to have an annual systems review to

assess and clarify senior management's understanding of the risks and also the setting and adjustment of the firm's risk appetite. Firms will be required to ensure that employees act in line with that appetite and are suitability trained on order entry procedures and controls and the prevention of market abuse. Staff must also be fully aware of when they can and cannot release orders into the market whilst also having an appreciation of what constitutes disorderly trading conditions. This is a complex area to navigate and one where Duff & Phelps' Kinetic Partners division has been actively involved in providing guidance and training to firms.

We have seen the pre-trade controls used by firms and venues developing significantly over the last few years for example with the introduction of circuit breakers which can be triggered in a variety of circumstances.

It is important that firms and venues conduct scenario based tests (in a non-production environment) which attempt to break these controls; thus creating a disorderly market scenario. Firms have asked us to help them think through the design, development and deployment cycle and associated controls as this is absolutely critical. We work together to prove that they cannot create a price-spike beyond reasonable parameters and that orders are suspended as expected under such circumstances. We develop tests to incorporate extreme scenarios, oversee market testing and help fine-tune the pre-trade control parameters.

European Securities and Markets Authority (ESMA) has emphasised that firms need automation for monitoring of algo activity and Direct Electronic Access (DEA) providers must monitor their credit and market risk on a real-time basis and suspend orders where necessary. In relation to market abuse, there is also an ongoing expectation for firms to monitor order activity for offences such as spoofing, quote stuffing, momentum ignition and smoking, the latter being a more recently defined type of market abuse.

The creation and ongoing maintenance of a Market Abuse Risk Assessment across all asset classes, coupled with the development of a market impact test pack are valuable tools required to mitigate the risk of a firm either creating a disorderly market or inadvertently facilitating market abuse. This is a good "insurance policy" in our experience.

For more information, please contact **Nick Inman** or **Judy Leung.**

CYBERSECURITY: DOING NOTHING RISKS 'NON-COMPLIANCE' AND SERIOUS BUSINESS DAMAGE

Banks, asset managers and hedge funds have made slow start in addressing regulations and guidelines on cybersecurity promoted by the Hong Kong SFC and US SEC. Response by the industry to security has been largely reactive to several breaches.

While there might be a perception that security breaches are something that happens to someone else. A study by Risk Based Security revealed that within the first nine months of 2014, 1,922 data breaches were reported and 904 million records exposed. Moreover, the number of security breaches is accelerating. Factoring in what was not reported, statistically speaking the chances of your company being subject to a security breach is now very real.

The price of indifference to cyber security is not just a potential regulation warning or fine, but possible damage to your business through the loss or theft of information. If such security breaches were revealed in the public domain the results can often be catastrophic. CEO's, COO's and senior management should be provided with information on the possible consequences of cyber threats. For example, consider the impacts of just these two threats:

Denial of service attack

That can consume the capacity of your IT network such that no trade orders can be made, emails cannot be sent or received and information on your trading activity cannot be reported. Effectively for a period of time your IT assets may be unusable hindering business activity.

Cyber espionage from the Internet

Your network is scanned and sensitive data is exported regarding clients or investments is stolen and put into the public domain. That will certainly attract regulator attention and damage your future business. Such types of incidents have tripled over 2014.

In combating the above threats, a first assumption might be that complex defence technology is required. To the contrary, quick preventative measures can be taken to defend against 99% of network security threats by a review of the update/configuration status of operating system, firewall, anti-virus software and enforcement of security procedures. However, to address the 1% of dangerous cyber threats, numerous solutions can be implemented. Yet, knowing where to start can be a problem.

Drawing on industry guidance from standards bodies to implement a comprehensive security gap analysis, followed by a risk based approach to identify the key cyber security threats for your business is a way to control the correct investment. A risk based approach involves performing an IT threat and vulnerability pair risk analysis, a type of analysis already enforced by MAS, the Singapore Financial Regulator. A solid outcome of this approach will put financial entities in an immediate position to defend their key information assets and provides an on-going security implementation plan as a result of gap analysis that addresses regulator concerns.

For more information, please contact **David Copland.**

A "MARA" HELPS YOU SLEEP AT NIGHT

On 22 June 2015, the FCA published its 48th Market Watch newsletter in which it suggested that *"Firms may wish to consider undertaking a detailed assessment of the market abuse risks to which they are exposed before designing a surveillance programme… For a number of firms, this work has allowed proportionate and appropriate surveillance to be designed and also highlighted where gaps exist that may require further development or manual surveillance techniques"*.

This newsletter has set alarm bells ringing among investment firms who are raising questions with us such as:

- What do firms need to have in their surveillance programme to effectively combat market abuse?
- What do the regulators expect market participants to have in place?
- What are others doing that we are not?

In order to determine what surveillance routines should be implemented to prevent and detect potential instances of market abuse, firms must first systematically identify the market abuse risks inherent to their business through undertaking a detailed Market Abuse Risk Assessment (MARA). The market abuse risks are then mapped against the firm's market surveillance control framework to identify where gaps exist and need to be remediated and this will then drive the firm's compliance surveillance book of work.

> It is essential that firms assess and document their market abuse risks in order to have effective and robust tools in place to mitigate these risks.

From our experience of working with firms to develop detailed MARAs, we found that the most effective and meaningful approach is to assess market abuse risks at a granular desk by desk level, by asset class and product type, and by each market abuse offence as detailed in the FCA Code of Market Conduct and ESMA Guidelines. However, it depends on the nature and size of the firm. This may mean identifying and assessing over 35 market abuse offences across Sales & Trading, Research and the Investment Banking private side in equities, credit, rates, commodities, FX and benchmark submissions.

Once the market abuse risks have been identified, firms should review for gaps in their trade surveillance, information barrier surveillance, voice and e-communication surveillance, compliance monitoring and testing, training, policies and procedures, governance and oversight, and business supervisory controls. A firm's MARA should be an evolving live tool that should be updated periodically to reflect changes to the business, market, regulatory landscape and control framework.

It is essential that firms assess and document their market abuse risks in order to have effective and robust tools in place to mitigate these risks. Not least because the Market Monitoring Team at the FCA continues to strengthen its group and improve its surveillance tools and techniques. Patrick Spens heads an army of sophisticated surveillance professionals whose mission is to detect unusual patterns and potential market abuse. The amount of fines and sanctions levied against individuals and firms is unlikely to abate in the coming years and firms will want to do their utmost to avoid the regulator's scrutiny.

For more information, please contact **Nick Inman** and **Simon Appleton.**

REMIT TRANSACTION REPORTING

By Joanna Williams at Reed Smith

REMIT covers trading in wholesale gas and power in the EU (wholesale energy products) as well as related transportation contracts and derivatives. Transaction reporting is one of the final REMIT requirements to be implemented.

Reporting for standard contracts in relation to the supply of electricity or natural gas started on 7 October 2015, with delivery in the EU and derivatives relating to electricity or natural gas produced, traded or delivered in the EU, in each case executed at an Organised Market Place (OMP), including matched and unmatched orders (Phase 1 Reporting Obligation). All other trades are reportable from 7 April 2016 (Phase 2 Reporting Obligation). Pre-existing trades that are still outstanding on the relevant start date are reportable within 90 days (Backloading).

Market participants (MPs) are required to register with a national regulatory authority (NRA) before they enter into reportable trades.

REMIT and the Implementing Regulation prescribe specific reporting channels through which trades must be reported to ACER's database, ARIS. Transactions subject to the Phase 1 Reporting Obligation must be reported through the OMP concerned (or through trade matching or trade reporting systems). The OMP is required to offer a data reporting agreement at the request of the MP (although no specific terms are prescribed). ACER has stated that an OMP is not under an obligation to offer Backloading. In practice, if they are technically capable of doing so, many OMPs are taking the commercial decision to offer it. MPs should check this with their OMP brokers and exchanges. OMPs must report to ACER through a registered reporting mechanism (RRM). There is no requirement for the RRM to be a party to the data reporting agreement offered by the OMP (although some are offering tripartite agreements where the relevant RRM agrees to this).

The Implementing Regulation provides that where a person reports through a third party, it will not be responsible for failures to report that are attributable to failures of the third party. It does, however, remain under an obligation to take "reasonable steps to verify the completeness, accuracy and timeliness" of that reported data . There was previously no guidance on what ACER regards as reasonable steps. What MPs can reasonably do now depends on the access they have to data reported to ACER on their behalf through an RRM. If the RRM is not a party to the OMP's data reporting agreement, MPs need to ensure this point is covered in a bilateral agreement between them and the relevant RRM. This continues to be one of the main areas of focus and concern when putting in place documentation and operational processes to comply with the Phase 1 Reporting Obligation.

Differing approaches to documentation, different technology solutions and the large number of OMPs and RRMs involved represent a significant challenge for all.

For more information, please contact **Joanna Williams.**

UPCOMING EVENTS

Valuation and compliance seminar, Hong Kong
Tuesday, 27 October

Valuation and Regulatory Developments, Singapore
Thursday, 29 October

U.S. Alternative Investments Summit, New York
Tuesday, 10 November

Women's Networking Event, Channel Islands
Wednesday, 18 November

For more information on upcoming events, visit **www.duffandphelps.com/aboutus/events**

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