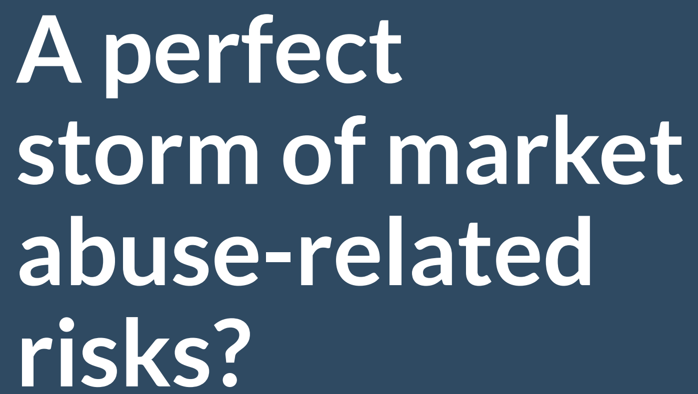
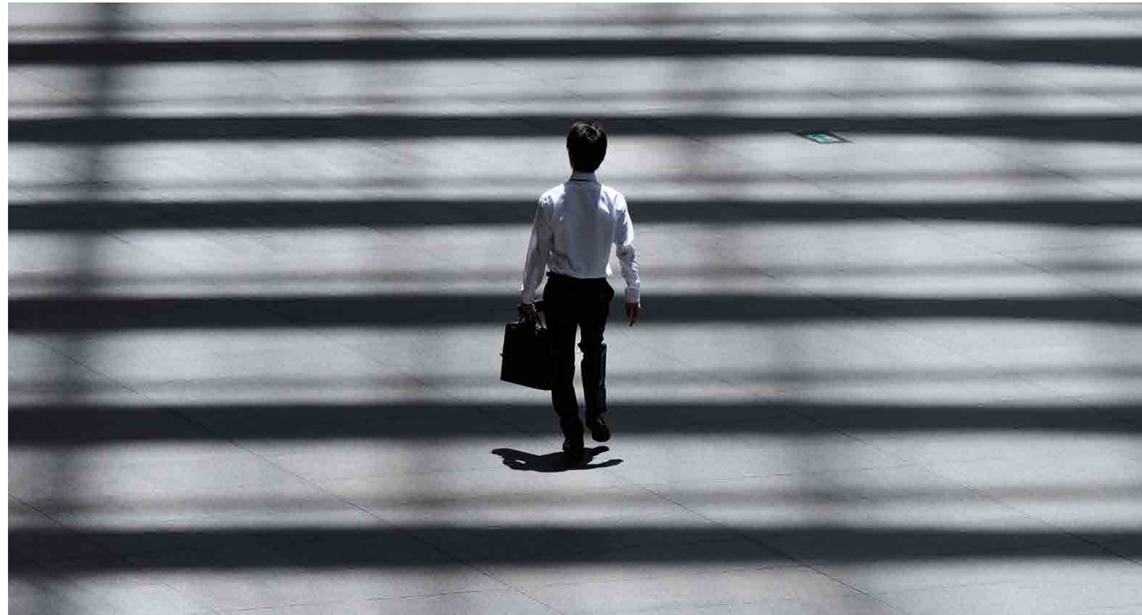


A perfect storm of market abuse-related risks?

Financial firms facing 8 key themes as compliance and ethics pressures mount

Risk Universe
by RiskBusiness



Now is the right time for financial services firms to take a serious look at the risk and control framework they have in place around market abuse, including insider trading. Quite a lot has changed over the past two years and more change is yet to come – changes in the markets, in data, in working locations and in regulatory approaches to supervision, just to name a few.

Below are eight themes that compliance and risk teams should explore as they think about the adjustments that might be needed to their firm's approach to detecting and preventing market abuse, as well as complying with applicable regulations. It's becoming increasingly clear that important stakeholders – regulators, investors and customers – have far less tolerance for incidents of this form of financial crime than a decade ago. However, in many firms, the risk and control framework may not have kept pace with the rapid evolution of this area.

These eight themes are intended to provide a brief, high-level overview and serve as a launching point for internal discussions within firms:

1 INCREASED USE OF SUPTECH

Both the US Securities and Exchange Commission (SEC) and the UK's Financial Conduct Authority (FCA) have invested significantly in supervisory technology (SupTech) over the past few years. This kind of technology applies sophisticated analytics to the trade data submitted by firms and other data sources to detect market abuse. For example, the US SEC has developed its National Exam Analytics Tool (NEAT), which combs trade data from investment advisors and broker dealers prior to exams. The High-Frequency Analytics Lab (HAL) focuses on detecting issues in high-frequency trading, while the ATLAS initiative can look for insider trading before a major equity event and spot serial insider trading. The UK FCA is developing similar tools,

and now receives more than 150 million order book messages per day. Surveillance algorithms look for a range of market abuse typologies, including spoofing and layering, marking the close, ramping, reference price gaming and wash trading. The regulator has publicly committed to investing £120 million more over three years in becoming a data and digital first regulator and it recently launched a new SupTech approach to short selling reporting and monitoring. It's planning on hiring more data scientists and data analysts too. All this means that it's becoming more likely that the regulator will spot market abuse before a firm's own compliance team does, dramatically increasing both the frequency and severity of market abuse-related compliance risk. For example, the FCA's algorithms identified Corrado Abbattista's large, misleading orders for Contracts for Difference. Abbattista, formerly a portfolio manager, partner and Chief Investment Officer at Fenician Capital Management LLP, was fined £100,000 and banned from performing any functions in relation to regulated activity by the FCA in December 2020.

2 GROWING FOCUS ON TRADE DATA QUALITY

Back before the pandemic hit, in 2019, regulators in the US, UK and EU were all becoming increasingly vocal about the quality of the trade data that firms were reporting into them. As mentioned in the preceding theme, regulators are relying more and more on this data to perform their own market abuse analytics, as part of their efforts to enhance market integrity. Poor quality data can impair their ability to conduct this surveillance. For example, the FCA opined about transaction data quality issues at firms in its Market Watch 59 newsletter in April 2019 and Market Watch 62 in October 2019. Past issues have included failing to report trades, populating the wrong fields and incorrect data. Many financial firms with legacy technology in their trade operations environment continue to face significant data governance and data quality challenges, which can translate into regulatory sanctions and reputational damage. Firms with poor quality data will be less likely to catch anyone committing market abuse through trade surveillance, increasing compliance risk. Poor quality can also impact other processes too, as the same data is often used for best execution and transaction cost analysis, as well as for risk management, for example. US regulators have also recently started handing out significant fines for erroneous, inadequate and untimely trade reporting, raising yet another compliance concern.

3 NEW DEMANDS FOR OPERATIONAL RESILIENCE

When the Covid-19 pandemic's first wave hit in March 2020, firms in many countries had to send traders to either work from home or to a remote business continuity location overnight. For many, this meant that suddenly, their trade surveillance systems could not monitor these employees in these new, out of the physical office locations. In particular, it often made capturing voice and electronic communications challenging. There were other issues too. For example, both regulators and compliance teams feared an increase in

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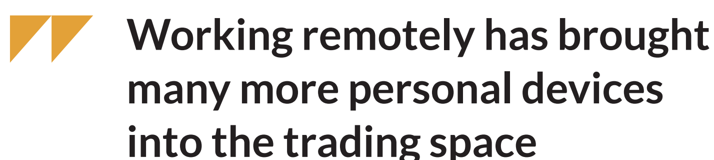
the transmission of material non-public information (MNPI), either on purpose or accidentally, to unauthorised individuals and a subsequent spike in insider trading. While at the time some regulators relaxed communications monitoring rules a bit to allow for the extraordinary circumstances, this has long since ended. Now, regulators expect firms to be able to monitor all communications and manage issues such as MNPI no matter where employees are working from. For example, the UK FCA set out its expectations in this area in its January 2021 Market Watch 66 newsletter. For many firms, this will mean ongoing investment to bring their trade surveillance software up to date, as well as additional training for employees and implementing other measures. Failure to ensure that market abuse prevention measures have sufficient operational resilience to withstand a pandemic, or other scenarios that require remote working, will increase compliance risk.

4 RISE IN ENFORCEMENT ACTIVITY AROUND MARKET ABUSE

Pre-pandemic, regulators around the globe were flexing their muscles around market abuse enforcement. For example, between 2015 and 2020 at the UK FCA, the number of open enforcement investigations into market abuse increased by 72%. Between 2016 and 2020, the UK FCA issued $2 billion in fines, while all US regulators combined issued a whopping $8 billion in fines. And it would be a mistake to think that enforcement activity ceased because of the pandemic – the US SEC had 22 market manipulation cases ongoing in 2020, compared with 30 in 2019, and 33 insider trading cases, compared with 30 in 2019. In a recent speech, the head of enforcement at the FCA listed prominent recent market abuse cases that had been resolved. The same attitude is present at the US SEC, where in September 2021 the regulator announced it was bringing charges against Sergei Polevikov, who worked as a quantitative analyst at two prominent asset management firms, for perpetrating a years-long front-running scheme that generated illicit profits of at least $8.5 million. It also is bringing charges against Jose Luis Casero Sanchez, a Spanish national and former senior compliance analyst in the Warsaw office of an international investment bank, for insider trading in advance of at least 45 corporate events involving the investment bank's clients. Now, all the signs are that globally, regulators intend to increase the focus on market abuse further. For example, market integrity remains a top three priority for the UK FCA in its 2021-2022 business plan.

5 EMERGING MARKET ABUSE CHALLENGES

Globally, there are a number of different areas where fresh market abuse issues are arising. One challenge is the new types of data, such as alternative data (alt data) and environment, social and governance (ESG) data. As traders explore using these data types to generate alpha, and ESG disclosures become mandatory, the classification of what is MNPI is stretching. Also, firms may need to soon implement – if they have not already – market abuse policies and processes around trading in crypto assets and currencies. As regulators move to put rules around the crypto space, firms should begin to address market abuse issues in this area. Lastly, regulators are starting to put much more focus on how firms monitor employees trading on their personal accounts. Working remotely has brought many more personal devices into the trading space and the proliferation of online trading platforms has exacerbated regulatory concerns. Many financial firms still have manual aspects to their personal account compliance processes – to be ahead of the curve, firms should look to automate personal account trading monitoring. Generally speaking, firms should be scanning the horizon for other emerging market abuse risks, such as the issues that arose as a result of the Gamestop/Reddit social media-propelled trading controversy in January 2021.



Working remotely has brought many more personal devices into the trading space

6 REGULATORY CHANGE

There is little doubt that the rules and guidance around market abuse will continue to evolve, accordingly risk and compliance teams will need to be ready to adapt to new requirements. For example, although the UK initially onshored the pre-existing EU Market Abuse Regulation (MAR) that it had been operating under pre-Brexit, most pundits expect regulatory divergence over the medium term as UK regulators seek to meet their market integrity goals. In the EU, the MAR review that was conducted in 2019 resulted in a report published in September 2020 that outlined several areas for revision and update. The European Securities and Markets Authority (ESMA) published a consultation on amendments to MAR guidelines on Delayed Disclosure of Inside Information in July 2021. The US SEC is considering new rules to help prevent social media feeding or enabling market abuse, after the GameStop/Reddit controversy. Over time, it's also highly likely that regulators will introduce new rules to help manage the emerging market abuse issues discussed above. In light of this significant regulatory risk, firms need to ensure that their market abuse programmes are sufficiently agile to adapt to regulatory change on an ongoing basis.

7 NURTURING AN ETHICAL CULTURE

With today's focus on ethical business – and recent industry scandals such as LIBOR fixing – it's more important than ever for firms to have the right culture across the business to prevent market abuse. With the increased focus of regulators on enforcement, the reputational damage that can result from fines and other sanctions related to market abuse are substantial. With the emerging prominence of ESG – and

> **Regulators are increasingly reviewing how well firms' market abuse software calibration models work**

increased demands from consumers that firms operate in an ethical way – financial firms can expect the reputational risk from market abuse events to only increase. One of the strongest weapons in the armoury of any compliance team doing battle with market abuse is the culture of the firm and this is even more true today, in the wake of increased remote working. Of course, there are key processes that firms should have in place, such as attestations, regular training and monitoring of voice and electronic communications, to support the culture. Best practice can also include ensuring traders make contemporaneous notes about the reasons for a particular trade and encouraging traders to consider how a trade might "look" from an outside perspective, not just whether it is legal or not. Today, compliance teams are also exploring psychological testing for certain roles and additional monitoring of employees working remotely. Tone from the top remains of vital importance in building the right compliance culture, too.

8 REASSESSING TRADE SURVEILLANCE TECHNOLOGY REQUIREMENTS

Many financial services firms will have implemented their trade surveillance platforms some years ago, while others may still have a considerable number of manual processes in place. Given how much is changing around market abuse, it may be time to consider whether the firm's current approach is effectively supporting risk and control objectives and how well it will be able to do so in the future. Other important technology considerations firms might want to review include how well their system is calibrated to send out alerts – many firms were swamped with alerts during the initial weeks of the pandemic, for example, while other firms may not be calibrated correctly to the kind of trading they do. Regulators are increasingly reviewing how well firms' market abuse software calibration models work. Firms might also want to consider how well non-equity trade surveillance – required since the implementation of the EU's Mifid II in January 2018 – is performing. Having the right technology in place can help ensure that the regulators don't come knocking on the door, having spotted a market abuse trading pattern that the firm missed. One analyst says that the market for trade surveillance software was $780.26 million in 2020 and is projected to reach $2.25 billion by 2028, growing at a CAGR of 14.2% from 2021 to 2028. Newer trade surveillance technologies usually employ machine learning (ML), artificial intelligence (AI) and natural language processing (NLP) to detect market abuse.

In conclusion, as a risk to firms, market abuse is rapidly evolving and so firms need to quickly raise their game too. A good starting point is to reassess the organisation's risk and control framework covering market abuse and to identify new and emerging risks that impact the firm, as well as potential control gaps. It's important to take into account new and developing market abuse regulation, national enforcement approaches and current and emerging patterns of market abuse activity. Firms should also assess their culture when it comes to market abuse and the quality of existing controls through the assessment process. Ideally, firms should benchmark themselves against their peers, where they are able to.

Overall, market abuse does seem to be on the rise and is therefore a substantial threat to firms, as well as to the integrity of the financial markets. Financial services firms that wish to manage risk well and also position themselves as an ethical organisation should consider strengthening their approach to market abuse.

FURTHER READING

Market Abuse Outlook: Overview of Global Regulatory Priorities and Focus Areas:
https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Financial-Services/gx-market-abuse-outlook-v3.pdf

The Use of Supervisory and Regulatory Technology by Authorities and Regulated Institutions – Market developments and financial stability implications:
https://www.fsb.org/wp-content/uploads/P091020.pdf

Trade Surveillance System Market Outlook – 2028:
https://www.alliedmarketresearch.com/trade-surveillance-system-market-A11313

FCA Market Watch 67, newsletter on market conduct and transaction reporting issues:
https://www.fca.org.uk/publications/newsletters/market-watch-67

Previous newsletters:
https://www.fca.org.uk/publications/newsletters/market-watch-66
https://www.fca.org.uk/publication/newsletters/market-watch-65.pdf

Locking down market abuse, a speech by Mark Steward, Executive Director of Enforcement and Market Oversight, delivered at the Expert Forum: Market Abuse 2021:
https://www.fca.org.uk/news/speeches/locking-down-market-abuse

Seizing opportunity – challenges and priorities for the FCA, a speech by FCA CEO, Nikhil Rathi, delivered at the Lord Mayor's City Banquet at Mansion House in September 2021,
https://www.fca.org.uk/news/speeches/seizing-opportunity-challenges-priorities-fca

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FCA 2021/2022 Business Plan: 2021 business plan:
https://www.fca.org.uk/publications/business-plans/2021-22

A statistical comparison of FCA and SEC enforcement actions:
https://www.akingump.com/en/news-insights/the-fca-and-sec-annual-reports-a-statistical-comparison.html

Recent US SEC recent enforcement cases:
https://www.sec.gov/news/press-release/2021-186
https://www.sec.gov/news/press-release/2021-203
https://www.sec.gov/news/press-release/2021-195

SEC plans to go after market manipulation on social media, executive insider trading, Gensler says,
https://www.marketwatch.com/story/sec-plans-to-go-after-market-manipulation-on-social-media-executive-insider-trading-gensler-says-11623093843

ESMA publishes on outcome of the Market Abuse Regulation Review:
https://www.esma.europa.eu/press-news/esma-news/esma-publishes-outcomes-mar-review

About Risk Universe

Risk Universe by RiskBusiness provides in-depth analysis, reviews and research on areas of interest within the broader governance, risk, audit and compliance landscape, designed to provide proactive, 360° intelligence for informed decision making across the enterprise.

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