FINANCIAL MARKETS AUTHORITY
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Market misconduct risks: a guide for MIS managers

This information sheet is to help Managed Investment Scheme (MIS) managers understand how to manage market misconduct risks in trading activity.

What we expect

Licensed managers of managed investment schemes need to comply with the minimum standards set out in the MIS manager licensing application guide, as well as all relevant legislation and regulations. This includes the requirement to manage market misconduct risks, such as insider trading or market manipulation, as well as client misconduct risks, such as trade allocation biases or lack of best execution. This information sheet is intended to supplement the guide by addressing market misconduct risks faced by managers who trade directly in financial products[1].

Directors and senior management are responsible for ensuring that 'doing the right thing' and putting client interests first are central to the culture of the firm. Policies, procedures, controls and reporting must address market misconduct risks and ensure that all trading activity is consistent with that culture. These should be tailored to the unique needs of the manager and be proportionate to the extent, nature and degree of potential market impact of the manager's trading.

More generally, directors and senior management are responsible for their internal governance arrangements and are accountable for all trading transacted in their firm's name, including proprietary trading accounts. This includes the conduct of their employees, whether performed by (or on behalf of) the manager or for personal accounts. We will take seriously any evidence of a lack of focus on, or commitment to, maintaining an adequate and effective risk and compliance framework.

Governance

Effective governance will require a thoughtful assessment of a firm's business structure and product offerings to determine the potential for market misconduct. Once this potential is determined, managers should develop methods to manage this risk and ensure compliance. This should include sufficient policies, procedures and controls to deter market misconduct, surveillance to detect any issues, and reporting to an appropriate level for any corrective action needed.

New staff need sufficient training to know what is, and is not, permissible. This should be reinforced through on-going training of all staff to build awareness of new legal and regulatory requirements, as well as changes in risks and the tools available to mitigate those risks.

Boards and senior management must be comfortable that, where possible, they have mitigated the risk of market misconduct and eliminated potential problems such as:

- lack of sufficient checks and balances in the risk and compliance reporting structure
- assuming that staff experience, without ongoing training or formal compliance policies, is sufficient to reduce the risk of abuse
- over-relying on external reviews of the risk and compliance framework

[1] Under FMC Act, s7(1), financial products refers to debt securities, equity securities, managed investment products, and derivatives. However, this information sheet does not apply to those investing solely in managed investment products. As noted in the outsourcing section of the licensing guide, MIS managers who mostly invest in other MISs still need to address the risk of market misconduct in their outsourced providers. However, the issues and responses in this situation are outside the scope of this information sheet.

- lack of sufficient reporting or management oversight, making compliance tools ineffective.

The risk and compliance framework should include ongoing monitoring, and reviews at least once a year, to consider:

- new and emerging risks
- changes to the firm's business model and size
- the current framework's adequacy and effectiveness in controlling market misconduct.

Managers must assess and respond to the potential market impact of trading strategies for specific transactions, as well as the general trading strategy.

Potential controls

Some examples of risk and compliance methods used worldwide by fund managers are listed below. This is not a complete list, and some may not be appropriate for a particular manager, but these have proven effective in controlling misconduct risk. Managers with higher-risk trading activities such as active trading strategies, proprietary trading, or those who have Direct Market Access (DMA) systems, which may lead to a higher likelihood of market misconduct, will need more robust controls than managers with lower-risk trading strategies.

Segregation of activity

Roles and responsibilities, locations, and reporting lines of different functions should be carefully considered and designed to enable robust checks and balances, and to minimise the risk of collusion or conflicts of interest. Front-office and back-office roles should be segregated and in different reporting lines. In some cases, segregation of portfolio management and trading functions may prove beneficial. Where these are not feasible or practical (given, for example, the nature of the trading activity and/or size of the manager) there should be additional oversight to minimise the potential for market misconduct.

Conflict of interest policy

Managers should carefully consider potential conflicts of interest and provide clear guidelines on how they will be addressed. Potential conflicts include personal holdings, trading by close relatives, the impact on trading activity of incentive-based conflicts such as performance fees, and extensive trading around performance reporting dates, such as portfolio pumping or window dressing. Another potential conflict is communicating with the media about specific securities or sectors. The commentary itself, as well as trading activity shortly beforehand or afterwards, should be monitored and assessed within the risk and compliance framework.

Insider information policy

Managers must control access to inside information. They must also have policies and procedures that limit the likelihood of inside information being received accidentally, or being received and not recognised as inside information. Managers also should consider how to address less obvious related risks. For example, managers may want to limit access to an issuer near known or expected corporate reporting dates, or provide additional oversight where staff speak to someone who has recently left employment with an issuer. There should be clear guidelines for reporting the receipt of any inside information, for maintaining its confidentiality, and for putting in place appropriate trading restrictions.

Restricted list

It is essential that an up-to-date list of securities with trading restrictions be consulted before trading in any relevant securities. Managers should have a policy for how this list is maintained and for how access to the list is controlled. This list should also be integrated into pre-trade and post-trade monitoring processes, including those related to personal trading.

Access controls

Price-sensitive information should be held on a need-to-know basis. Methods of controlling internal use of information include physical separation of business units, electronic protection of systems, and information barriers. If information barriers are used, policies should include provisions for staff considered to be on 'both sides of the wall' or 'above the wall'. Control of sensitive information, including limits on disseminating the identity of companies on the restricted list, can prevent staff from inadvertently becoming restricted.

Access to trading systems, including DMA systems, should be controlled so that the identity of anyone making a trade will be known, and trading cannot occur without proper authorisation. Managers using DMA should consider the broker-imposed filters and DMA controls in forming internal policies. However, managers remain responsible for their own trading activity, and should not solely rely on broker controls to manage their own conduct obligations.

Personal holdings and trading policy

All staff with access to investment information should report their personal holdings, and regularly update this. Managers may want to consider broadening this requirement to other staff. Personal trades, including those of close relatives, should be monitored and pre-approved to ensure individuals are not benefitting from non-public information, or taking advantage of pending trade activity by the manager. Boards and management may want to consider whether personal trading is appropriate for staff conducting or overseeing trading activity.

Pre-trade controls

Pre-trade controls can be effective in ensuring that trading activity conforms to policy. However, we recognise the need for rapid decision-making, and that various trading limitations may not be integrated into a single trading system. There is likely to be a trade-off between the extent of preventive controls and post-trade monitoring.

Mapping of trade orders

There should be a monitoring process for all executed trades enabling comparison to specific trade orders and investment strategies. Trading activity that does not appear to be consistent with the current investment strategy, or with delegated trading authority, warrants further attention.

Post-trade monitoring and reporting

Managers should develop guidelines for the post-trade monitoring, detection, and assessment of potentially suspicious trades. Trades found to be compliant should be noted. Those that are not, or that require further consideration, should be escalated to the appropriate management level. Post-trade monitoring reports should be a regular agenda item of senior management or the board, as appropriate. Potentially suspicious trades could include:

- aggregated trading activity exceeding a dollar or volume threshold, especially when the trades occur immediately after the open or before the close
- trading occurring close to a performance reporting period end, that may have the intent of setting the market price
- trading that represents a significant proportion of activity in a particular stock or sector (for example, where market share on any particular day, or over a specified period, exceeds a certain percentage)
- multiple small trades that appear to have the intent of setting the market price rather than implementing a portfolio strategy, especially those that are small relative to overall portfolio holdings
- trading patterns — including both buys and sells — in a short period of time, particularly where multiple small orders in one direction over a relatively short intra-day period appear to move prices, followed by a sizeable order in the other direction

- trades made via different brokers where this is not necessary for best execution, or over multiple DMA accounts
- trades that do not conform to, or align with, the current investment strategy
- trades immediately preceding material corporate announcements.

There should be post-trade monitoring of personal and proprietary trading to ensure compliance to policy, including a clear protocol for reporting to senior management. Trades should be analysed to determine patterns of behaviour that may not be apparent on a pre-trade basis. This surveillance should be able to identify any suspected attempts at market manipulation, including those that have the effect of raising the price of a financial product.

Managers should have the appropriate number of staff to monitor trading activities and ensure compliance with the firm's risk and compliance framework. Senior management with investment expertise should also be required either to sign off or take action on any suspicious trades. The framework should include a policy on what trades will be reviewed and how often, how the trading analysis will be reported, and how this information will be used by management.

Evolving issues and responses

The methods and examples listed above are potential responses managers should consider to deter and detect market misconduct. As noted above, directors and senior management will need to review their businesses and consider what is appropriate for their situation.