Corterum

Conduct Rules Scenarios
Front-running

Scenario

You are the Head of Compliance for Mega Bank PLC. You have just been notified about conduct involving Joe Bloggs, a Certification Employee and trader on the bank's foreign exchange desk. On two separate occasions in 2018 and 2019, Joe Bloggs misused confidential information provided by a client, Hyper Fund. Hyper Fund had hired Mega Bank to execute multi-billion dollar foreign exchange transactions involving USD and GBP. After executing confidentiality agreements with Hyper Fund that required Mega Bank to keep the details of the planned transactions confidential, Joe Bloggs transacted in GBP for personal benefit and for the benefit of Mega Bank's "proprietary" accounts. Joe Bloggs subsequently executed the transactions on behalf of Hyper Fund in a manner designed to drive the price of GBP in a direction that benefited Mega Bank and harmed Hyper Fund. Harry Smith, a Senior Manager who is Head of FX at Mega Bank and Joe Blogg's line manager, subsequently made misrepresentations to Hyper Fund which concealed the self-serving nature of the transactions. In total, Mega Bank made profits of approximately USD 38.4 million on the 2018 transaction and approximately USD 8 million on the transaction in 2019.

What conduct rules may have been breached?

- Individual Conduct Rule 1: "You must act with integrity".
- Individual Conduct Rule 4: "You must pay due regard to the interests of customers and treat them fairly".
- Individual Conduct Rule 5: "You must observe proper standards of market conduct".
- Senior Manager Conduct Rule 1: "You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively".
- Senior Manager Conduct Rule 2: "You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system".

Points to consider

General

The conduct in question does relate to the regulated or unregulated "financial activities" of the firm. As such, the conduct should be considered as being in-scope for the purposes of the Conduct Rules.

Bear in mind that, under COCON 3.1.3G, a person will only be in breach of a Conduct Rule where they are personally culpable. In other words, the person's conduct must have been:

1. Deliberate, or
2. Below the standard of conduct that would be reasonable in all of the circumstances.

Pursuant to COCON 3.1.2G, in assessing whether a breach of the Conduct Rules has occurred, the FCA will have regard to the context in which a course of conduct was undertaken, including:

1. The precise circumstances of the individual case,
2. The characteristics of the particular function performed by the individual in question, and
3. The behaviour expected of that function.

The FCA will also take into account whether the conduct in question (a) relates to activities that are subject to other provisions of the FCA Handbook, or (b) is consistent with the requirements and standards of the regulatory system (as far as it applies to the firm).

Pursuant to COCON 3.1.5G and 3.1.6G, in determining whether a breach of the Senior Manager Conduct Rules has occurred, the FCA will take into account:

1. Whether the Senior Manager exercised reasonable care when considering the information available to them,
2. Whether the Senior Manager reached a reasonable conclusion upon which to act,
3. The nature, scale and complexity of the firm's business (the smaller and less complex the business, the less detailed and extensive the systems of control in place need to be – and vice versa),
4. The role and responsibility of the Senior Manager as determined by reference to his/her Statement of Responsibilities, and
5. The knowledge which the Senior Manager had, or should have had, of regulatory concerns (if any) relating to their role and responsibilities.

Joe Bloggs

Joe Bloggs' conduct is a clear breach of **Individual Conduct Rule 1**: "You must act with integrity". 'Misleading (or attempting to mislead) a client' forms the essence of this breach and is one of the non-exhaustive list of examples provided by the FCA of the types of conduct that will constitute a breach of **Individual Conduct Rule 1**. 'Misusing confidential information' and 'front running client orders' are also provided by the FCA as two further examples of conduct that will constitute a breach of **Individual Conduct Rule 1**. On the face of it, it seems clear that Joe Bloggs is guilty on both counts.

Joe Bloggs is also likely to be in breach of **Individual Conduct Rule 1** by virtue of failing to disclose his personal account dealing but, compared to the seriousness of the offence, this is likely to be a relatively minor consideration in practice.

Joe Bloggs' conduct is also likely to constitute a **criminal offence**, but discussion of that is beyond the scope of this document.

In front running a client order and executing transactions on behalf of the client at rates that were less favourable than would otherwise have been the case (or the client could legitimately have expected), Joe Bloggs will have also breached **Individual Conduct Rule 4**. This requires Joe Bloggs to "pay due regard to the interests of customers and treat them fairly".

Finally, **Individual Conduct Rule 5** requires Joe Bloggs to "observe proper standards of market conduct". Clearly, front running a client order cannot be considered to be 'observing proper standards of market conduct'.

Beyond simply looking at whether a Conduct Rules breach has occurred, whether Joe Bloggs remains **fit and proper** to perform his role must be questionable. If, following an investigation, there is any substance to the allegations against Joe Bloggs, an in-year fit and proper assessment should be triggered. On the facts as we have them, Joe Bloggs would not seem to satisfy the requirements regarding "honesty, integrity and reputation" to be considered fit and proper. If not, his certificate should be withdrawn.

<u>Harry Smith</u>

In lying to the client, Harry Smith has also breached **Individual Conduct Rule 1**, **Individual Conduct Rule 4** and **Individual Conduct Rule 5**. The analysis of this is largely the same as for Joe Bloggs and relates to his lack of honesty and integrity, as well as his disregard for the interests of his clients or proper standards of market conduct.

However, Harry Smith is also a Senior Manager. As such, he is subject to the Senior Manager Conduct Rules in addition to the Individual Conduct Rules. More specifically, on the basis of his misrepresentation of the situation to the client, it seems likely that Harry Smith will have also breached **Senior Manager Conduct Rule 1** and **Senior Manager Conduct Rule 2**.

Senior Manager Conduct Rule 1 requires Harry Smith to 'take reasonable steps to ensure that the business of the firm for which he is responsible is controlled effectively'. Much of the FCA guidance on **Senior Manager Conduct Rule 1** focuses on the organisation of the business and the need for clearly defined allocation of responsibilities and clear reporting lines. However, there is also a requirement for senior managers to satisfy themselves that 'appropriate policies and procedures for reviewing the competence, knowledge, skills and performance' of each individual member of staff exist. Moreover, where performance is unsatisfactory, the Senior Manager should review "carefully" whether to allow the individual in question to continue in their position. The conclusion must be that creation of an environment where dishonest and possibly criminal behaviour are not only tolerated but actually promoted would also result in a breach of **Senior Manager Conduct Rule 1**. In these circumstances, it seems impossible to conclude that the business is being 'controlled effectively'.

Senior Manager Conduct Rule 2 requires Harry Smith to 'take reasonable steps to ensure that the business of the firm for which he is responsible complies with the relevant requirements and standards of the regulatory system'. As part of its guidance on this requirement, the FCA expects Senior Managers to take reasonable steps to deal with actual or suspected breaches of regulatory requirements within their area of responsibility 'in a timely and appropriate manner'. Front running a client order and then lying to the client as part of a 'cover up' are not consonant with ensuring that the business continues to operate in accordance with regulatory requirements and so cannot be considered to be compatible with **Senior Manager Conduct Rule 2**.

All breaches of the Conduct Rules must be reported to the FCA. However, whilst breaches by Joe Bloggs (a Certification Employee) need only be reported once a year, any breach by Harry Smith (a Senior Manager) must be reported to the FCA within **7 days**.

As with Joe Bloggs, questions must also be asked as to whether Harry Smith remains fit and proper to perform his role as a Senior Manager. On the facts as presented, his willingness to lie to a client of the firm suggests that he does not have the "honesty, integrity and reputation" necessary to be considered to be fit and proper.

This scenario is based on a real-life example of front running. In practice, the controls which the bank in question implemented as a result of the episode included:

1. Implementing algorithmic trading to manage risk around benchmark orders;
2. Updating policies for sales, pricing, order handling, managing confidential client information and conflicts of interest, pre-hedging, and market abuse;
3. Engaging outside firms to audit its internal controls and
4. Enhancing its trade, voice, and audio surveillance.