

Conduct Rules Scenarios

Star Trader Covers Up Losses

Scenario

You are a compliance officer working for Trusty Broker Ltd.

Mick Freeson is a trader in the equities division, working out of the Singapore office. Mick has been classified as a “Material Risk Taker”. For a long time, Mick has been regarded as a star performer – ostensibly generating huge profits for the firm.

However, the truth of the situation has now come to light. In reality, Mick had been incurring significant losses on proprietary positions and ‘hiding’ them in a secret “5 sevens” account. He has also produced confirmations for a number of fictitious trades in order to cover his tracks.

The Product Control and Compliance departments had no knowledge of the “5 sevens” account or the fictitious trading activity. How Mick managed to do this without Product Control and Compliance becoming aware is not yet known.

Ron Laker, Mick Freeson’s boss and the Senior Manager in charge of the equities division was also completely unaware of the losses that Mick Freeson had been accumulating. A later investigation would uncover the fact that Mick Freeson had been allowed to both enter into, and settle, his own trades – effectively occupying both a front- and a back-office position within Trusty Broker Ltd.

What conduct rules may have been breached?

- Individual Conduct Rule 1: “You must act with integrity”.
- Individual Conduct Rule 2: “You must act with due skill, care and diligence”.
- 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.

In terms of the territorial application of the Conduct Rules, in general the Conduct Rules only apply to ‘UK activity’. More specifically, the Conduct Rules apply to:

1. Conduct performed from an establishment maintained in the UK by a firm which is subject to the SM&CR, or
2. Conduct which involves dealing with a UK-based client of a UK firm which is subject to the SM&CR from an establishment overseas.

However, the Conduct Rules apply to the conduct of the following individuals wherever it is performed:

1. A Senior Manager, or
2. An employee of an SM&CR firm who performs the function of a Senior Manager, or
3. A non-executive director, or
4. A Certification Employee who performs Certification Function (6) (“Material Risk Taker”).

Mick Freeson

Mick Freeson is not a Senior Manager. As such, the Senior Manager Conduct Rules do not apply to him. However, on the facts as they are presented, it seems clear that Mick Freeson has breached **Individual Conduct Rule 1**, which requires all individuals who are subject to the Conduct Rules to “act with integrity”.

The fact that Mick Freeson works out of the Singapore office will not exclude the application of the Conduct Rules in this scenario. The Conduct Rules apply to the conduct of a “Material Risk Taker” (such as Mick Freeson) wherever that conduct takes place. As such, there is no limitation of the application of the Conduct Rules to ‘UK conduct’ in the case of Mick Freeson.

On the facts presented in the scenario, we can only conclude that Mick Freeson’s actions were deliberate. As such, he can be regarded as satisfying the ‘personal culpability’ pre-condition of liability under the Conduct Rules.

In creating the “5 sevens” account, Mick misled Trusty Brokers Ltd. In order to support his cover-up operation, Mick also mismarked his positions and falsified trading records.

In its COCON guidance, the FCA provides a number of examples of conduct which would constitute a breach of **Individual Conduct Rule 1** which directly tie back to Mick Freeson’s behaviour. These include:

1. Misleading (or attempting to mislead) by act or omission the firm for whom the person works,
2. Falsifying documents,
3. Mismarking the value of investments or trading positions,
4. Providing false or inaccurate information,
5. Misleading others in the firm about the nature of risks being accepted,
6. Failing to inform, without reasonable cause, the firm for whom the person works of the fact that their understanding of a material issue is incorrect, despite being aware of their misunderstanding,
7. Preparing inaccurate trading confirmations, contract notes or other records of transactions, and
8. Designing transactions to disguise breaches of requirements and standards of the regulatory system.

It goes without saying that Mick should have informed his line manager (and probably also the Compliance Department directly) who, in turn, should have escalated the matter until the Senior Manager with responsibility for the equities trading division had become aware.

Ultimately, the firm will have to notify FCA of this matter. Normally, breaches of the Conduct Rules by non-Senior Managers must be notified to the FCA annually in October using Form H (also known as “REP008 – Notification of Disciplinary Action”). However, the following types of breaches must be reported to the FCA “immediately”:

1. Any “significant” breach of a Conduct Rule (SUP 15.1.7G(1) and SUP 15.3.11R(1)(a)), or
2. Any matter that could have a significant adverse effect on the firm’s reputation (SUP 15.3.1R(3)), or
3. The occurrence of any fraud with respect to any member of staff (SUP 15.2.17R).

On the basis of the facts as we have them, it would seem that the firm should notify the FCA immediately about Mick Freeson’s conduct and its impact on the firm.

Ron Laker

There is no suggestion that Ron Laker knew anything about the conduct of Mick Freeson. Therefore, there is nothing to suggest that Ron Laker has breached **Individual Conduct Rule 1**.

Of more relevance to the analysis of Ron’s Laker’s liability is **Individual Conduct Rule 2** and **Senior Manager Conduct Rule 1**.

Individual Conduct Rule 2 requires all individuals who are subject to the Conduct Rules to “act with due skill, care and diligence”. The FCA provides specific guidance as to how this rule should be interpreted in the context of a manager (note that this person does not have to be a Senior Manager, although Ron Laker is a Senior Manager). The FCA stresses that it is important for a manager to understand the business for which they are responsible. The FCA accepts that a manager is unlikely to be an expert in all aspects of a complex financial services business. Nonetheless, a manager is expected to understand and inform themselves about their business sufficiently to understand the risks of its trading, credit or other business activities.

A breach of **Individual Conduct Rule 2** will occur where there is a failure on the part of a manager to take reasonable steps:

1. to ensure that the business for which the manager has responsibility is controlled effectively,
2. to ensure that the business for which the manager is responsible complies with regulatory requirements,
3. to ensure that effective oversight of delegated responsibilities is implemented, or

4. to adequately inform themselves about the business for which they are responsible.

In this sense, as far as it relates to managers, there is significant overlap between **Individual Conduct Rule 2** and **Senior Manager Conduct Rule 1**.

Senior Manager Conduct Rule 1 requires Senior Managers to 'take reasonable steps to ensure that the business of the firm for which they are responsible is controlled effectively'. In order to discharge this obligation, Senior Managers should take reasonable steps to ensure that the business for which they are responsible has operating procedures and systems with well-defined steps for complying with the detail of regulatory requirements. They should also take reasonable steps to ensure that actual or suspected breaches of regulation are dealt with in a "timely and appropriate manner".

The FCA provides a number of relevant examples of the types of conduct that could constitute a breach of **Senior Manager Conduct Rule 1**. These include:

1. Failing to take reasonable steps to implement adequate and appropriate systems of control to ensure compliance with regulatory requirements,
2. Failing to take reasonable steps to monitor compliance with regulatory requirements, and
3. Failing to take reasonable care to oversee the establishment and maintenance of appropriate systems and controls.

Put simply, on the facts of the matter, it seems that Ron Laker has been 'asleep at the wheel'. He has not implemented any of the controls one could reasonably expect to be in place between a trading function and a risk function. It seems impossible to conclude that Ron Laker has taken the steps that are necessary to ensure that the business for which he is responsible is controlled effectively. Had he done this, Mick Freeson would not have been in a position where he could settle his own trades. As such, his fraudulent trading activity would likely have been noticed much earlier in the piece. One can only imagine that the FCA would find it impossible to conclude that he had "exercised reasonable care" as required by COCON 3.1.5G and 3.1.6G. Furthermore, one can only conclude that his failure to implement any kind of controls 'falls below the standard of conduct that would be reasonable in all of the circumstances'. As such, he must surely be regarded as personally culpable (as required by COCON 3.1.3G). On this basis, we have to conclude that Ron Laker is in breach of **Senior Manager Conduct Rule 1**.

Remember, as Ron Laker is a Senior Manager, pursuant to SUP 10C Annex 2G, any breach of the Conduct Rules would have to be notified to the FCA within 7 days.

Other points to consider

Now that you have become aware of Mick Freeson's conduct, you should inform your line manager immediately.

Ultimately, the SMF16 (Compliance Oversight) should be made aware of the matter as it

seems likely that there are weaknesses in controls from the Compliance side which allowed Mick to open the “5 sevens” account and hide his trading losses in the first place. On this basis, **Senior Manager Conduct Rule 2** becomes relevant.

Senior Manager Conduct Rule 2 requires Senior Managers to ‘take reasonable steps to ensure that the business of the firm for which they are responsible complies with the relevant requirements and standards of the regulatory system’. Examples of the types of conduct that would constitute a breach of **Senior Manager Conduct Rule 2** include:

1. Failure to implement adequate and appropriate controls, or
2. Failure to monitor compliance, or
3. Failure to review systems of control, or
4. Failure to ensure that the compliance department has sufficient authority, resources, expertise and access to information in order to effectively discharge its duties.

On the facts of this scenario, we do not have sufficient detail to conclude definitively whether or not there has been a breach of **Senior Manager Conduct Rule 2**. However, at the very least, there is a prima facie case for the Head of Compliance to answer. As such, the matter should be investigated thoroughly.