Conduct Rules Scenarios
The Rogue Algorithm

Scenario

Alice is a Certification Employee ("Algorithmic trading"). She is responsible for the development and deployment of algorithms for Super Broker Ltd.

Alice's algorithm has been in deployment for 18 months when she realises that there is an error in the way in which it executes transactions on behalf of clients. Essentially, the error is that time zone differences have not been factored in properly during the order execution process. As a result, client orders have not been executed in a timely manner.

Looking back over the last 18 months, Alice estimates that clients have lost approximately £2 million pounds as a result. Six months ago, Alice's algorithm was subject to review by both the Compliance Department and Internal Audit. Neither function noticed the error embedded deep within the code of the algorithm.

Super Broker Ltd collected commission on all of the orders placed in the normal course of business.

It is 2 months until bonus time. Alice corrects the algorithm but decides to 'let sleeping dogs lie' as far as the historical problems with the algorithm are concerned.

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".
- Individual Conduct Rule 4: "You must pay due regard to the interests of customers and treat them fairly".

Points to consider

General

In order to be considered in-scope for the purposes of the Conduct Rules, the conduct in question must relate to the regulated or unregulated "financial activities" of the firm.

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").

Ultimately, the firm will have to notify the FCA of any breach of the Conduct Rules. Normally, breaches of the Conduct Rules by <u>non-Senior Managers</u> 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).

The FCA must be notified of any breach of the Conduct Rules by a Senior Manager within 7 days, pursuant to SUP 10C Annex 2G.

<u>Alice</u>

Alice's conduct does relate to the regulated or unregulated "financial activities" of Super Broker Ltd. As such, it is in-scope for the purposes of the Conduct Rules. Obviously, Alice is a Certification Employee, but not a Senior Manager. As such, only the Individual Conduct Rules apply to Alice, not the Senior Manager Conduct Rules.

The defect in the original construction of the algorithm may be a breach of **Individual Conduct Rule 2**. **Individual Conduct Rule 2** requires Alice to 'act with due skill, care and diligence'. The FCA makes clear that due skill, care and diligence are required, <u>especially where activities might affect customers</u> or the integrity of the financial system.

Algorithms may be complex, but time zone differences are a known element in cross-border trading and correctly executing a trade across different time zones is not an insurmountable task.

On the face of it, Alice's failure to factor in time zone differences could be regarded as a failure which falls below the standard of conduct that would be reasonable in all of the circumstances – particularly given the extra care that should have been taken due to the fact that clients are involved. If so, the pre-conditions regarding personal culpability, as required by COCON 3.1.3G, would be satisfied.

Alice's failure to report or escalate the matter is likely to be a breach of **Individual Conduct Rule 1**. **Individual Conduct Rule 1** requires Alice to 'act with integrity'. On the facts that we have, her conduct did not start out as downright fraudulent. Rather this seems more likely to have been a genuine mistake. Nonetheless, at the point at which the error became known by Alice, integrity (in terms of what Alice does next) is a factor of key relevance.

The FCA provides a non-exhaustive list of examples of conduct that would constitute a breach of **Individual Conduct Rule 1**. These include:

1. Misleading (or attempting to mislead) by act or omission a client or the firm for whom the person works,
2. Failing to inform, without reasonable cause, a customer or the firm for which the person works of the fact that their understanding of a material issue is incorrect, despite being aware of their misunderstanding,
3. Not paying due regard to the interests of a customer, or
4. Acts, omissions or business practices that could be reasonably expected to cause customer detriment.

In light of her decision to 'let sleeping dogs lie', despite the fact that she is aware that clients have lost money as a result leads to the conclusion that she is highly likely to have breached **Individual Conduct Rule 1**. The decision appears to be deliberate and, to that extent, Alice satisfies the requirements of 'personal culpability'. The fact that her decision was taken near bonus time is not – of itself – conclusive proof of anything. However, at the very least, it is further circumstantial evidence that her actions lacked integrity.

Alice's failure to report or escalate the impact that the algorithm had on clients is also like to be a breach of **Individual Conduct Rule 4**. Pursuant to Individual Conduct Rule 4, Alice is required to 'pay due regard to the interests of customers and treat them fairly'.

The FCA provides a non-exhaustive list of examples of conduct that would constitute a breach of **Individual Conduct Rule 4**. These include:

1. Failing to inform a customer of material information in circumstances where they were aware, or ought to have been aware, of such information and of the fact that they should provide it, and
2. Failing to acknowledge, or seek to resolve, mistakes in dealing with customers.

On the facts as we have them, it seems clear that in deciding to 'let sleeping dogs lie' and allow clients of Super Broker Ltd to suffer a loss in these circumstances, Alice has breached **Individual Conduct Rule 4**. Again, that decision was deliberate and, to that extent, satisfies requirements around 'personal culpability'.

Under normal circumstances, Super Broker Ltd would have to notify the FCA of any breach of the Conduct Rules by someone in Alice's position 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).

Given Alice's conduct, the better view would be that the FCA should be notified about the matter immediately.

Consideration should also be given to whether Alice remains fit and proper to perform her role. Whilst an in-depth discussion of fit and proper testing is beyond the scope of this document, fit and proper assessments rest on three 'pillars':

1. Honesty, integrity and reputation,
2. Competence and capability, and
3. Financial soundness.

In Alice's case, any fit and proper assessment is likely to focus on the first 'pillar' (honesty, integrity and reputation) and the second 'pillar' (competence and capability). Putting aside questions of 'competence and capability', on the facts of this matter, it seems impossible to conclude that Alice has the requisite honesty or integrity to remain in her role. She has committed, at best, a serious error of judgment and, at worst, a criminal offence. The fact that clients are involved and have suffered losses can only be regarded as an aggravating factor.

Taking a step back, Alice should have reported the matter to her line manage immediately upon becoming aware of the issue. Super Broker Ltd may still have reached the conclusion that she had breached **Individual Conduct Rule 2** on account of a failure to 'act with due skill, care and diligence'. However, reporting the matter immediately would have gone a long way to protecting her against allegations that she lacks honesty and integrity (which form the basis of the breaches of **Individual Conduct Rule 1** and **Individual Conduct Rule 4**.

In turn, Super Broker Ltd should report the matter to the FCA immediately, given its seriousness. The firm should also investigate what losses have been experienced by clients and provide redress.