Conduct Rules Scenarios
Trading in Gamestop Shares

Scenario

Olivia is a young analyst. She has recently joined the grad scheme at Trusty Brokers Ltd, earning £27,000 p.a.

She has been a member of the "r/wallstreetbets" investment forum for about six months. After reading about all of the excitement surrounding Gamestop shares and how it is a "sure bet", Olivia decides to invest in the stock. She has always lived by the mantra "go big, or go home".

Olivia invests the entirety of her savings (£20,000) in Gamestop shares. She also uses three credit cards to make further investments of £10,000 per credit card. Therefore, in total, she invests £50,000 in shares of Gamestop.

Unfortunately, for Olivia, she buys right at the top of the market, when the shares are valued at approximately USD 350 each. Over the course of the next day, the price of Gamestop shares crashes in value. Olivia loses 80% of her initial investment - £40,000 in total.

Olivia was not aware of Trusty Brokers' personal account dealing rules and has not disclosed her investment in Gamestop shares.

With much of her salary going to pay the rent on her flat, Olivia does not know how she will pay the debts that she has racked up on her credit cards.

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".

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 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).

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.

Olivia

Is Olivia's investment in Gamestop shares to be regarded as relating to the regulated or unregulated "financial activities" of the firm? After all, it is a personal investment. If it is, her conduct is in-scope for the purposes of the Conduct Rules. If it is not, her conduct is out-of-scope for the purposes of the Conduct Rules. On balance, it is probably better to regard Olivia's conduct as being in-scope for the purposes of the Conduct Rules. Breach of personal account dealing rules is specifically mentioned as an example of conduct that would constitute a breach of **Individual Conduct Rule 1**. That being the case, it would be strange indeed if this conduct was to be regarded as out-of-scope generally for the purposes of the Conduct Rules.

Undoubtedly, Olivia should have obtained the approval of her employer before making the initial investment in Gamestop shares. But has she actually breached any Conduct Rules by failing to do so?

Individual Conduct Rule 1 requires Olivia to 'act with integrity'. The FCA provides a non-exhaustive list of examples of the type of conduct that would constitute a breach of **Individual Conduct Rule 1**. One such example is “failing to disclose dealings where disclosure is required by the firm’s personal account dealing rules”. Ostensibly, therefore, Olivia would seem to be in breach of **Individual Conduct Rule 1**.

However, ultimately, whether or not Olivia is to be regarded as being in breach of **Individual Conduct Rule 1** or not may depend on whether she satisfies the “personal culpability” requirement of the Conduct Rules generally.

As previously mentioned, 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 (a) deliberate, or (b) below the standard of conduct that would be reasonable in all of the circumstances. On the facts that we have, Olivia did not seem to be aware of the personal account dealing policy. On that basis, we can probably conclude that her actions were not deliberate. As such, it may be that her culpability depends on whether her conduct fell below that would was ‘reasonable in the circumstances’. Unfortunately, we do not have sufficient detail to reach a definitive conclusion on this. Was she actually informed of the personal account dealing policy? If not, it may well be that she is not “personally culpable” and so has not breached the Conduct Rules (although it may be indicative of weaknesses in the training given to new recruits). If so, and – for example – she simply chose not to read the policy or forgot that it existed, it may well be that she has satisfied the “personal culpability’ condition and therefore would be regarded as being in breach of **Individual Conduct Rule 1**. Either way, the fact that she is a junior member of the team would likely be regarded as a mitigating factor.

In not informing herself about the existence of the contents of the personal account dealing policy of Trusty Brokers Ltd, it could be said that Olivia had not exercised ‘due care and diligence’. If so, it is possible that she could be in breach of **Individual Conduct Rule 2**. Personal account dealing policies are there for a reason – to avoid insider trading, to avoid conflicts of interest, to avoid analysts promoting the virtues of a stock into which they have already personally invested.

Even if she was not aware of the contents of the Trust Brokers Ltd personal account dealing policy, it is at least arguable that Olivia (even considering the fact that she is junior) should have known that such a thing a personal account dealing policies exist generally. If so, it becomes relatively easy to conclude that her conduct was ‘below the standard that would be reasonable in all of the circumstances’. As such, again, she would satisfy the “personal culpability” pre-requisite for liability under the Conduct Rules.

Under normal circumstances, Trusty Brokers Ltd would have to notify the FCA of any breach of the Conduct Rules by a non-Senior Manager like Olivia annually in October using Form H (also known as “REP008 – Notification of Disciplinary Action”). Some breaches of the Conduct Rules must be reported to the FCA “immediately”. These include:

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).

However, none of the ‘immediate exceptions’ would seem to be relevant to Olivia’s conduct. As such, it would seem best to simply make a ‘normal’ notification on Form H.

Consideration should also be given to whether Olivia 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 the case of Olivia, any fit and proper assessment is likely to focus on the first ‘pillar’ (honesty, integrity and reputation) and the third ‘pillar’ (financial soundness). We have already discussed some of the factors around Olivia’s integrity. With respect to ‘financial soundness’, Olivia has incurred significant losses (and debts) compared to her earnings. However, the fact that she is still junior and her earning capacity should grow in the future is likely to be a mitigating factor.

<u>Other things to consider</u>

It is possible that the Senior Manager with the Prescribed Responsibility for the implementation of the Conduct Rules may have some kind of liability in these circumstances. It seems clear that Olivia did not know all of the rules that she is subject to. Whilst personal account dealing does not form part of the SM&CR per se, the episode may provide evidence of the fact that training generally could be improved.