Market Watch 73

This Edition in Brief

The FCA has published its 73rd Market Watch Newsletter, discussing its observations and findings from the recent market abuse peer review into firms that offer Contracts for Difference ('CFDs') and Spread Bets ('CFD providers'). This edition is linked to Market Watch 69, which discusses firms' arrangements for market abuse surveillance - drawing on observations from the FCA's engagements with small and medium-sized firms.

CFD market abuse peer review

The CFD and spread bet market abuse peer review looked at nine firms' processes and procedures and risk assessments, assessing each firm's business model, market abuse risks, and arrangements for detecting and reporting market manipulation. The aim was to better understand how firms that offer CFDs and spread bets are identifying and reporting potential market abuse and to raise standards.

The 73rd Market Watch sets out the findings from the review and focuses on CFDs and spread bets because of the associated market abuse risks, including:

- CFDs and spread bets are particularly vulnerable to being used for insider dealing due to their speculative and leveraged nature, with single stock equities being the predominant risk.
- They are a significant source of the FCA's Suspicious Transaction and Order Reports ('STORs').
- Gaps in surveillance were observed, namely in non-equity asset classes.

The FCA's overall findings were largely positive. All firms have surveillance in place to detect insider dealing, most of which are considered effective. However, they did observe some weaknesses, such as the lack of consideration of market abuse risks in non-equity asset classes and market manipulation, and a number of areas that require improvement.

Market Abuse Risks

Observation:

All firms had policies and procedures setting out roles and responsibilities for market abuse surveillance and for investigating and escalating alerts from their surveillance systems. However, Not all firms could demonstrate they had considered all market abuse risks relevant to their business.

FCA's view on the issue:

Risk assessments need to be more thorough. "To maintain effective arrangements, systems, and procedures to detect and report suspicious orders and transactions, firms need to understand how they could facilitate market abuse. If done properly, undertaking a risk assessment is an effective and efficient way of achieving this. It enables a firm to document all the market abuse risks that apply to its business and consider what monitoring it needs to detect them in a structured and comprehensive way. A general assessment of market abuse policies and procedures does not achieve this."

Market Abuse Surveillance Responsibilities

Observation:

Most firms do not have effective surveillance for non-equity asset classes, and a range of different setups are used. Another area of concern is that firms do not monitor for unrealized profits, either specifically, or by capturing them via discrete alerts, such as news or price movements, which operate independently of profit. There are circumstances where clients may not necessarily close positions quickly. Where this happens, and firms do not consider unrealized profits, they will fail to identify potential market abuse.

FCA's view on the issue:

Firms should consider whether their surveillance coverage is adequate for market manipulation and in non-equity asset classes. Firms that review all trading activity before an event, rather than limit investigations to the alerted trading, will be more effective at identifying potential market abuse that falls outside the system parameters.

Surveillance Systems

Observation:

The focus of FCA's review was 'narrowing the spread', a type of market manipulation that FCA believe to be increasing, where the activity aims to influence the prices of spread bets or CFDs by narrowing the spread in the underlying market, typically in illiquid stocks. In their review, the FCA found that while most firms were aware of this activity, no firm had listed it in their risk assessments or had Compliance-based surveillance to detect it.

FCA's view on the issue:

If a firm identifies narrowing the spread as a relevant market abuse risk, a complete and accurate risk assessment document would include this as a risk. Firms providing DMA access to clients should also be aware of potentially unusual activity where clients are improving the best bid or offer – particularly if using very small order sizes – and rarely executing those orders, as a potential indicator of narrowing the spread.

Surveillance Alert System

Observation:

When reviewing alerts, some firms are not considering the client's trading history. While many factors are important when creating an overall picture of a client or event, a client's trading history is an important factor to consider to sufficiently assess reasonable suspicion of market abuse. "For example, when firms look at the publication of a blog article or increased options volumes, considering the probability of a client consistently trading only in those stocks where a blog article/increased options volume was followed by a significant news story and movement in price would be helpful in detecting market abuse."

FCA's view on the issue:

Firms should include all relevant information available to them when investigating alerts and ensure they record the rationale for their mitigation

While most of the FCA's findings were positive, this edition of Market Watch focuses on areas requiring improvement. The FCA asks CFD providers to consider the points made, take steps to ensure their systems and procedures for detecting and reporting potential market abuse are appropriate and proportionate, and ensure they have effective policies and procedures to counter the risk they are used to further market abuse related financial crime. The FCA will continue to visit CFD providers and other firms to assess their suspicious transaction and order reports and work to ensure they meet their regulatory obligations.