FICC MARKETS
STANDARDS BOARD

FICC Markets Standards Board

Conduct Risk in Market Transactions

Statement of Good Practice for FICC Market participants

Transparency Draft

July 2018

I Introduction

1. The FICC Markets Standards Board

The FICC Markets Standards Board ("FMSB") was established in 2015 in response to the Fair and Effective Markets Review in the UK with a mandate to issue Standards designed to improve conduct and raise standards in the wholesale Fixed Income, Commodity and Currency ("FICC") markets. FMSB will work to build up a body of Standards and Statements of Good Practice over time, prioritising those areas where its Members consider there is a lack of clarity in the standards of behaviour expected of market participants, or a lack of understanding of the issues relevant to a product or transaction type, or evidence of poor conduct.

2. Applicability of FMSB Statements of Good Practice

FMSB Statements of Good Practice are issued by FMSB from time to time. Statements of Good Practice do not form part of the FMSB Standards and they are not subject to FMSB's adherence framework. Rather they reflect FMSB's view of what constitutes good or best practice in the areas covered by the Statement of Good Practice in question. FMSB members are expected, and other firms are invited, to consider their own practices in light of the Statement of Good Practice and make any changes to such practices that they deem to be appropriate. Failing to do so will not, however, create any presumption or implication that a firm has failed to meet its regulatory or other obligations.

Full details of FMSB Member firms are available at www.fmsb.com. Statements of Good Practice will be shared with non-Member firms and their associations, who are encouraged to consider them. Information on Statements of Good Practice will be made available to users of the wholesale FICC markets (e.g. corporates and end investors) so that they may be made aware of their existence and the FMSB's expectation of market conduct.

FMSB will as part of its normal course of business, periodically review the applicability of its published Statements of Good Practice to ensure they are relevant and up to date for market conditions.

3. Relationship with law and regulation

FMSB Standards and Statements of Good Practice do not impose legal or regulatory obligations on FMSB members, nor do they take the place of regulation. Rather they serve as a supplement to any and all applicable law, rules and regulation. In developing Standards and Statements of Good Practice, relevant regulators will in many cases have commented on their drafting, alongside Member Firms and other bodies, such that the Standards and Statements of Good Practice once finalised and published are intended to represent an authoritative statement of global good practices and processes.

4. Relationship with other Codes

Other Codes already exist in relation to certain FICC markets, such as the FX Global Code, whilst others are in the process of being produced. There will be some overlap between the work of the FMSB and such other bodies and the FMSB will seek to ensure it adopts a consistent approach in cases of overlap wherever possible and will seek to avoid issuing a Standard or Statement of Good Practice where the subject matter is already covered adequately by existing regulation or a Code issued by another body. It may, however, draw the attention of Member Firms to an existing Code.

II Scope

This document applies to participants in FICC markets in the execution, management and oversight of market activity.

The scope of this document is not designed for any particular market participant, business or control function. It provides Good Practice Statements for the use of a conduct risk taxonomy for the identification and assessment of conduct risk.

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III Background

Conduct risk is an inherent risk of participation in all financial markets, including wholesale markets. The behaviour of staff and the manner in which they undertake market transactions is one of the main risks of misconduct.

The response to recent conduct issues has been the development of a new regulatory approach which emphasises the alignment of behaviour, conduct, governance and culture. The development of this approach requires an equal focus to be given to market conduct as well as on process and rules.

A number of factors contribute to the continuity of behavioural conduct risks. There is insufficient recognition that the same malpractice behaviours repeat; occur across asset classes and jurisdictions; adapt to new media and market structures; and are not described in rules and laws. A better recognition would lead to a reinforcement of continuity of collective memory in addressing behavioural conduct risks.

Laws and rules are key pillars of the regulatory regime but are not specifically designed to catalogue market practice and conduct. What is acceptable and unacceptable in daily conduct and practice is implied by but is not specified in rules. Rules may mean that certain practices are permissible (or not), but they do not specify those practices. By necessity, these rules and laws are sometimes written and brought into force with hindsight after an instance of misconduct has occurred. This means that censure is often based upon principles-based regulation which can differ between jurisdictions and does not provide ex-ante guidance to market participants.

The Fair and Effective Markets Review (FEMR) required that further work be undertaken by the industry to provide guidance on aberrant conduct in wholesale markets. This requires the identification of common adverse conduct behaviours. It also requires the production of real life case studies, and the use of market read across and analysis of international sources relating to wholesale market misconduct in the provision of guidance to the market. This requirement is echoed by market authorities, such as the FCA in the UK, who pursue the approaches of market read across and credible deterrence.

FMSB has developed a methodology called Behavioural Cluster Analysis (see Section IV for detail) which identifies and provides a taxonomy of the core group of misconduct techniques which have repeatedly formed the basis of misconduct across multiple jurisdictions. These patterns are jurisdictionally neutral, occur in multiple asset classes and repeat over extended time periods. To give one example, the pattern of behaviour used by Captain de Berenger in 1814 to manipulate the price of UK government debt in London was no different to that used in 2005 by Zafar and Thawani to manipulate microcap stocks in the US.

This paper sets out Good Practice Statements for the identification of conduct risks in market transactions using this methodology. The identification of conduct risk is an important role undertaken by the Front Office, as well as by control and oversight functions, and firms should consider their own practices in light of this Statement of Good Practice and make any changes to such practices that they deem to be appropriate.

IV FMSB Behavioural Cluster Analysis

Context

FMSB has used Behavioural Cluster Analysis ("BCA") to address a number of requirements of the FMSB that were stipulated in the FEMR. These include:

(i) **Real Life Case Studies**. The provision of real life case studies in areas detrimental to the effective operation of markets. It was considered that real-life case studies which sought to explain (but not define) market practices through practical examples could perform a useful role in improving the practical application of standards.

(ii) **Market Read Across**. That market participants identify the causes of misconduct and apply those lessons to other business lines that may initially appear unrelated and ensure that conduct lessons learned in one business area are applied elsewhere.

(iii) **International and Cross Market Sources**. That FMSB leverage the experience of other markets, jurisdictions and wholesale misconduct cases.

(iv) **Collective Memory**. As industry participants turn over new actors take their place. The new actors have no experience of the failings of the past. The evidence demonstrates that these behaviours recur. Efforts to reinforce collective memory by identifying the techniques and setting them out in enduring media are required to pre-empt this.

Methodology and Scope

(i) **BCA Methodology**. BCA is an evidence-based methodology based on analysis of the patterns of behaviours in actual market conduct cases brought by regulatory and other enforcement authorities. Enforcement cases and similar source materials describing actual adverse conduct are reviewed to ascertain the pattern of behaviour indicated in each case. These are compared with those in other cases to determine whether the same behaviours repeat or are unique or different in each case. The outcomes are then compared to those in other jurisdictions to establish if the same similarities exist.

(ii) **BCA Scope.** The BCA review of behavioural patterns is based upon 390 cases in 26 countries over an extended period (200 years) in multiple asset classes, including non-FICC markets, in order to satisfy the FEMR requirements for Market Read Across and consideration of international and cross-market cases. BCA indicates that there is not a limitless horizon of misconduct that occurs in market transactions. There are some 25 behavioural patterns evident in market misconduct cases. These patterns repeat and recur over time and are evident in international markets and multiple asset classes. BCA establishes that there is a more limited horizon of behaviours which can be identified and actioned.

(iii) **Regulatory Alignment.** The regulatory response to recent conduct issues has been the development of a new regulatory approach which emphasises the alignment of behaviour, conduct, governance and culture. This approach requires a focus upon practice and conduct and not just upon process and "rules". BCA is derived from real cases of market misconduct and is behavioural. BCA is aligned to, and seeks to support and advance, the conduct and behavioural agenda of regulatory authorities.

Thematic Findings

BCA has yielded a number of thematic findings.

Finding 1: **There are a Limited Number of Repeat Behavioural Patterns**. Review of source materials indicates that there are some 25 behavioural patterns evident in market misconduct cases. These patterns repeat and recur.

Finding 2: **Behavioural Patterns are Jurisdictionally, Geographically and Asset Class Neutral**. These patterns do not respect national or jurisdictional boundaries. They are evident internationally and are not specific to particular asset classes. This is rational: asset classes do not generate conduct risks – people do.

Finding 3: **Behaviours Adapt to New Technologies and Market Structures**. Technology is not new – it has been a feature for markets for years, and as such there is corresponding body of evidence of conduct malpractice in the screen-based trading environment. These behaviours are not new – they are known behaviours that have adapted to new media.

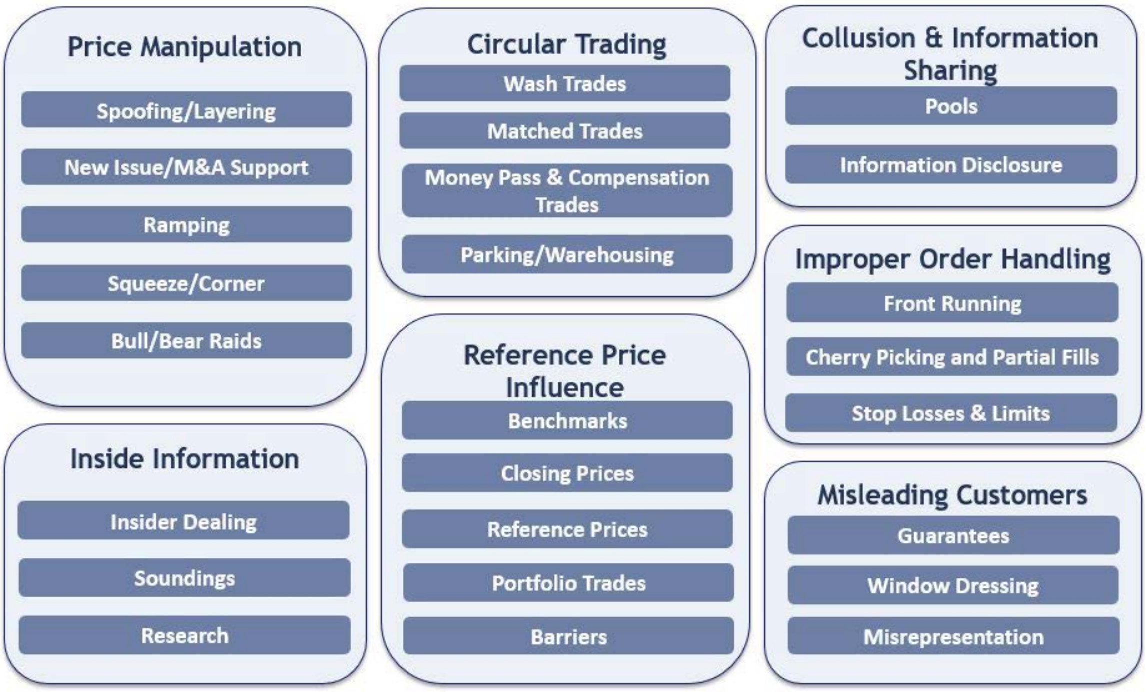
Behavioural Patterns

(i) **Patterns not Definitions**. BCA is an exercise in the collation and analysis of behavioural patterns for the purposes of recognition, and hence to support, inter-alia, management oversight, training and control function oversight. As such, BCA does not seek to provide legal or regulatory definitions of particular practices. Readers and users may wish to re-classify clusters based on their own analysis or interpretation of source materials. Similarly, readers and users will need to consider which clusters are relevant to their individual business models and the markets in which they operate.

(ii) **Patterns not Purpose.** The objective of BCA is not to distinguish clusters or cases by the purpose of the actors. The same techniques can be deployed for multiple purposes, can be adapted to new market structures and can be used in combination. The aim is to identify and address the more limited number of tools and techniques which are repeatedly used to advance a broader range of misconduct in market transactions.

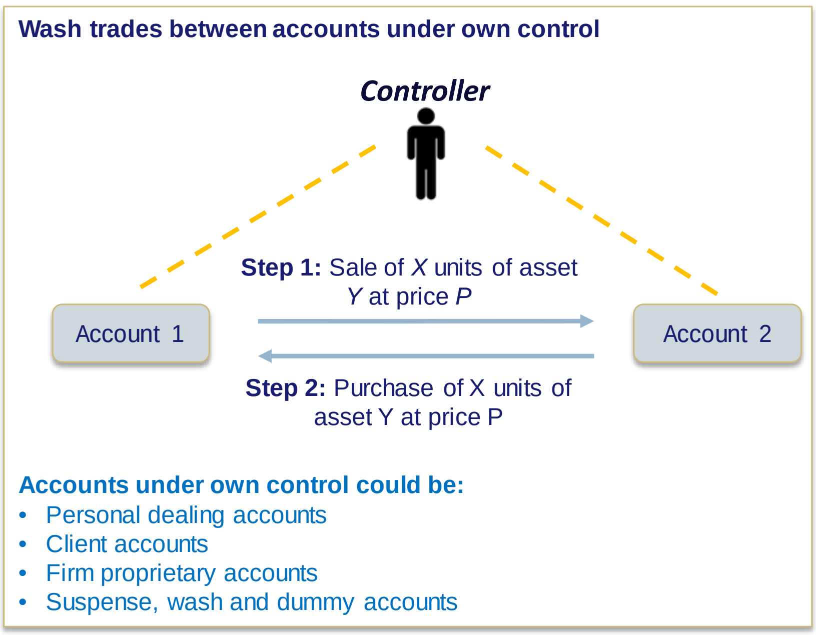
(iii) **Patterns and markets.** It is self-evident that all BCA patterns do not arise in all market activities and products. For example, clusters relevant to new issues of securities are not relevant to commodities markets in which there is no new issuance.

(iv) **Clusters.** FMSB has identified the following behavioural patterns from source materials:



(v) **Example cluster:**

Wash trades are one cluster of misconduct. These can be conducted in a number of ways which are discussed and evidenced further in the source material referenced below. One way that a wash trade can be affected is shown below:



Reference and Source Materials.

FMSB has produced a number of supporting and reference publications which explain the BCA methodology, provide more detailed information as to the behavioural patterns in question to aid identification and recognition, and case study material. These publications are:

(i) **FMSB: Behavioural Cluster Analysis, Misconduct Patterns in Financial Markets**. This publication describes the BCA methodology and sets out each relevant conduct pattern, pattern diagrams where appropriate and a summary of key source cases. The purpose of the document is to provide a collated reference source for each relevant pattern.

(ii) **FMSB: Misconduct Patterns in Financial Markets Selected Case Studies**. This publication provides real life case studies. It sets out summaries of the relevant cases from which each pattern is derived. This can be used for reference, education and or training.

(iii) **FMSB: Database, Market Abuse and Manipulation: Historic Cases.** This publication is a collated database of all source cases used in the BCA exercise. This can be used for further reference and analysis and demonstrates that the BCA methodology and outputs are verifiable and broadly based.

V Good Practice Statements

Taxonomy

Good Practice Statement 1: Firms should have a taxonomy for the identification and assessment of common conduct risks that may occur in market transactions and that are relevant to their business.

Firms should develop taxonomies which identify the conduct risks that can occur in market transactions. This should be informed by incidents of misconduct that have been identified by regulators and by the firm's own analysis of the market activity it conducts.

Behavioural Cluster Analysis, as described in Section IV, provides a taxonomy of adverse behavioural patterns that have been observed in market transactions and censured by regulators or the courts.

BCA is an evidence-based methodology based on analysis of the patterns of behaviours in actual market conduct cases brought by regulatory and other enforcement authorities. By definition these constitute "real life examples" of observed market conduct. The adverse behavioural patterns identified by BCA are derived from domestic and international regulatory and legal actions not theory.

The classification of behavioural patterns can be achieved in alternative ways or to different levels of specificity. Firms should consider their own taxonomies and compare them to the classifications determined empirically by BCA to determine if additions or improvements are required or appropriate.

Good Practice Statement 2: Firms should periodically assess the nature and impact of new conduct events to ensure that existing taxonomies continue to cover known behaviours.

Firms should consider the frequency at which their conduct risk taxonomy should be reviewed and be aware that events may necessitate an ad hoc review.

Events which may require ad hoc review of the conduct risk taxonomy include:

- Incidents of misconduct occurring within the firm constituting internal breaches of policy or breaches of regulation and/or law.
- Significant observed external events or misconduct.
- Entering into new business or market activities that could give rise to additional conduct risks.

The database of misconduct cases which supports the BCA taxonomy as published by the FMSB will be reviewed by the FMSB on an annual basis in light of the outcomes of regulatory enforcement actions and legal cases concluded in that period.

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Risk Oversight and Training

Good Practice Statement 3: Supervisors should consider whether their supervisory tools and processes allow sufficient oversight of potential misconduct in market transactions.

Implementation of effective front office supervisory frameworks promotes the integrity and effectiveness of financial markets leading to better outcomes for all market participants. Staff whose activities could have direct adverse impact on fair and effective functioning of markets and those who have mandates to take on primary business risks on behalf of their firms should be subject to supervision in this manner.

Guidance on how firms can implement effective front office supervisory frameworks is provided in the FMSB Statement of Good Practice for Front Office Supervision. Of particular relevance on this topic is Good Practise Statement 12 which states that "Firms should provide their supervisors with sufficient tools and information to enable them to carry out their supervisory duties and supervisors should satisfy themselves that they have the right tools and data to discharge their duties."

Good Practice Statement 4: Staff should receive formal training on the conduct risks of market transactions and the behavioural patterns that can lead to misconduct.

Training on potentially adverse patterns of behaviour can take different forms and typically includes a mixture of Code of Conduct training and affirmation, training delivered by front office and compliance in partnership, and embedded elements of conduct in other qualifications or programmes. It is important that training is tailored to the asset class and relevant business units.

The FMSB Statement of Good Practice for Conduct Training provides further guidance on how firms can deliver conduct training.

In particular, Good Practice Statement 4 identifies the need for:

> *"Better usage of real-case scenarios to translate high level principles into actionable guidance for their employees…Training aimed at developing better decision-making skills for employees, including helping employees recognise where a situation presents conduct issues and what factors or questions they should consider when determining the right way to proceed."*

BCA outputs demonstrate clearly and in a market relevant fashion the core patterns of prescribed behaviours and may be used to provide real case scenarios for this purpose.

If relevant, case studies of misconduct that have occurred with the firm can also form an effective training tool.

Control and Oversight

Good Practice Statement 5: Firms should embed a consistent understanding of misconduct in market transactions throughout the firm's risk management and policy framework underpinned by their own taxonomy.

In large financial institutions, there are typically a number of different functional teams within the firm that need to understand market abuse and its associated behavioural patterns. In contrast, at smaller firms the number of market facing individuals and those responsible for control and oversight will be correspondingly smaller. However, in all instances, a consistent understanding of the patterns that can constitute market abuse aids in the identification, management and mitigation of behavioural conduct risks.

Firms should consider how they can embed conduct risk taxonomies in their risk management framework. This may include for example consistent use of the taxonomy in policies and procedures that relate to the identification and assessment of conduct risk, through to the maintenance of monitoring and surveillance frameworks.

Governance and MI

Good Practice Statement 6: Firms should develop management information based on their conduct risk taxonomies that allows governance fora and senior management to consider and challenge the conduct risks identified in the market transactions of the firm.

The outputs of the risk identification and assessment process should inform the decision-making of governance fora and senior management who are tasked with making decisions as to the firm's strategy, risk profile and operating model.

Good Practice Statement 7: Firms should ensure that the output of their risk identification and assessment process informs the development of policies and procedures that are sufficiently detailed to address the identified risks.

Policies and procedures should be adequately detailed to provide guidance to assist employees in addressing identified risks.

Good Practice Statement 8: Firms should ensure that the output of their risk identification and assessment process informs the development of monitoring and surveillance to address the identified risks.

The risk identification and assessment process should be used to inform the development and maintenance of risk-based automated surveillance as well as more proactive and/or manual monitoring programmes as appropriate.