MFSA MALTA FINANCIAL SERVICES AUTHORITY

Circular

29 April 2020

Circular on Regulation (EU) No 596/2014 on Market Abuse - Onsite Compliance Meetings with Investment Firms: General Findings & Way Forward

Executive Summary

Since 2018, the Malta Financial Services Authority ('MFSA') has been holding a number of onsite compliance meetings relating to Regulation (EU) Nº 596/2014, with investment firms falling within the scope of MAR.

The purpose of the onsite compliance meetings was for the MFSA to verify the extent of implementation of the Regulation by the investment firms and to assess the relevant systems, arrangements, policies and procedures which investment firms are required to have in place in order to detect and report suspicious orders and transactions in accordance with Article 16 of MAR.

This circular presents **the MFSA's** findings relating to how investment firms control the risk of financial market abuse. Without prejudice, the circular also provides recommendations of what are considered to be good practices for investment firms to seek to adhere to their legal obligations under MAR. Please note that such recommendations are only aimed to provide guidance and should not be in any way construed as legal advice and/or interpretation. The obligation to ensure that the investment firm satisfies the requirements of the applicable laws and that its policies and procedures are kept up-to-date, rests solely with the directors of the investment firm. Furthermore, **this circular provides the MFSA's position as at the date of publication and is** subject to any clarifications which ESMA might issue from time to time.

Key Findings

Core to the regime in place to protect markets from financial abuse, is the requirement imposed on investment firms to identify reasonable grounds to suspect market abuse and consequently submit STORs to the Authority. The MFSA is of the view that effective monitoring for suspected market abuse cannot be conducted unless firms have appropriate trade monitoring systems and staff with sufficient training and expertise to make appropriate judgements.

The MFSA's main finding following the compliance meetings was that, whereas investment firms did have some measures in place in order to mitigate susceptibility to market abuse, such measures were not comprehensive, and almost all investment firms did not have sufficient systems in place to detect and report suspicious orders and transactions, whilst the policies and procedures adopted were incomplete. The lack of proper organisation and control to responsibly and effectively detect financial market abuse, in turn heightens the risk of failing to submit Suspicious Transactions and Orders Reports ('STORs').

An effective framework to prevent and detect market abuse

Our thematic review focused on requirements considered to be key in preventing and detecting market abuse.

With respect to investment firms this includes (but is not limited to):

- Ensuring a proper structure is in place for the transmission of STORs;
- Having policies and procedures in place ensuring that the respective obligations of investment firms are adhered to in practice, including, but not limited to, requirements relating to market soundings;
- The implementation of arrangements and systems, regularly assessed and equipped to allow for pre-trade controls and post-trade surveillance;
- Effective controls in place to monitor staff dealing;
- Staff training to provide the necessary skills to prevent and detect financial market abuse; and
- Objective presentation of investment recommendations and statistics.

In view of the above, MFSA officials from Securities and Markets Supervision monitored the outcome of the onsite compliance meetings and have identified a number of issues which were commonly raised during these meetings.

Findings

Market Soundings

MAR formalises a regime for conducting market soundings. In terms of Article 11 of MAR, a market sounding comprises the communication of information prior to the announcement of a transaction, in order to gauge the interest of potential investors in a possible transaction and the conditions relating to it, such as its potential size or pricing, to one or more potential investors. Under this Article, specifically point (d) of sub-Article 1 thereof, investment firms acting on behalf or on the account of a person referred to in point (a), (b) or (c) of Article 11(1) of MAR are considered to be disclosing market participants ('DMPs'). Consequently, investment firms are subject to certain obligations during the course of a market sounding in accordance with Article 11 of MAR, Commission Delegated Regulation (EU) 2016/958 and Commission Implementing Regulation (EU) 2016/959. During the course of the market sounding, the investment firm must *inter alia*:-

- Have in place procedures describing the manner in which market soundings are conducted;
- Determine whether the information to be disclosed constitutes inside information whilst keeping a written record of its conclusion and the reasons thereof;
- Prior to disclosure of the inside information, obtain the consent of the intended recipient to receive such information and their agreement to keep such information confidential;
- Inform the intended recipient that they are prohibited from undertaking transactions in financial instruments relating to the inside information;
- Maintain a record of all information disclosed and the identity of the potential investors to whom information is disclosed and the date and time of each disclosure; and
- Inform the recipients as soon as possible once such information ceases to be inside information.

Investment firms stated that generally they did not engage in market soundings on behalf of issuers, secondary offerors and so on, nonetheless, there were investment firms which intended to carry out a market sounding in the future. Even though a number of the investment firms, stated that they had never carried out market soundings, they held policies and procedures relating to the same. Having said that, the Authority was of the view that such policies and procedures required revision and improvements, as they did not encompass all the requirements in terms of Article 11 of MAR and the respective implementing and delegating regulations. Furthermore, the investment firms which had actually carried out market soundings, kept minimal and incomplete documentation that could confirm their adherence to the market soundings requirements under MAR.

Recommended Good Practice

As a minimum investment firms acting as DMPs are expected to have the following:
 	
· Establish arrangements and procedures for the conduct of market soundings to comply with Article 11 of MAR and the respective delegated and implementing regulation, which procedures must be regularly reviewed and updated where necessary. Records of the procedures must also be kept in a durable medium for at least five years;
· Before carrying out each market sounding the standard set of information must be determined (taking into account that the information is necessary and appropriate) and used with all recipients of the market sounding. A record of the standard set of information must also be kept for at least five years;
· Consider whether the market sounding will involve the disclosure of inside information, make a written record of the conclusion and the reasons for it. The written record must be provided to the MFSA upon request. If the disclosure involves inside information, the DMP must:
  – Consider how consent to receive inside information will be sought from the market sounding recipients ('MSRs'); and
  – Determine to the extent possible, when the inside information will cease to be inside information. An estimate of when the information will cease to be inside information, the factors that may alter that estimate and information as to how the MSRs will be informed of any changes in such estimate;
· Communication of the information relating to the market soundings may take place orally, in physical meetings, in audio or video telephone calls, or in writing, by mail, fax or in electronic communications;

- The DMP must also draw up a separate list for each market sounding which includes the following information:-
  - The names of all the natural and legal persons to whom information has been disclosed in the course of the market sounding;
  - The date and time of each communication of information which has taken place in the course of or following the market sounding; and
  - The contact details of the persons receiving the market sounding used for the purposes of the market sounding;
- If the market sounding is conducted through telephone calls or recorded video or audio meetings, the recordings should be kept on file for at least five years. In the event that, the market sounding takes place through unrecorded meetings or telephone calls the written minutes or notes must be drawn up in accordance with the requirements contained in Commission Implementing Regulation (EU) 2016/959.;
- Before making the disclosure, a number of statements and confirmations must be carried out by the DMP pursuant to Article 11(5) of MAR.

It is recommended that investment firms maintain good record-keeping to prove adherence to the applicable requirements. Furthermore, investment firms should ensure that 'cleansing'[1] following a market sounding takes place, such that investors who were privy to the inside information as a result of the market soundings, know that they are no longer in possession of inside information.

Prevention and Detection of Financial Market Abuse

The MFSA considers investment firms to be the first line of defence in the prevention and detection of financial market abuse. Therefore, we expect investment firms to remain vigilant and to take a proactive approach towards preventing and detecting market abuse.

[1] 'Cleansing' refers to informing market sounding recipients when information disclosed during a sounding ceases to be inside information.

Effective Arrangements, Systems and Procedures to Detect and Report Suspicious Orders and Transactions

In terms of Article 16(2) of MAR, any persons professionally arranging or executing transactions[2] are required to establish and maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions. Where such a person has a reasonable suspicion that an order or transaction in any financial instrument, whether placed or executed on or outside a trading venue, could constitute insider dealing, market manipulation or attempted insider dealing or market manipulation, the person is obliged to notify the MFSA without delay.

The systems and arrangements which investment firms are required and expected to have in place should be adequately suitable to detect financial market abuse, by *inter alia*:

i. Capturing data (including, pre-trade and post-trade data, news and announcements; as well as internal data, such as client positions);
ii. Allowing the investment firm to analyse the data (such analysis should watch out for certain indicators of market abuse, such as significant volume or significant change in price[3]);
iii. Providing Alerts/ Allowing firms to Raise Suspicion;
iv. Facilitating the provision Suspicious Orders and Transactions Reports (STORs).

Similarly, Article 2(1) of Commission Delegated Regulation 2016/957 requires persons professionally arranging or executing transactions to establish and maintain arrangements, systems and procedures that ensure the effective and ongoing monitoring, for the purpose of detecting and identifying orders and transactions that could constitute insider dealing, market manipulation or attempted insider dealing or market manipulation, of all orders received and transmitted and all transactions executed.

During a number of onsite compliance meetings carried out at investment firms, the Authority identified concerns relating to the integrity and completeness of the arrangements and systems being used by investment firms for conducting routine surveillance. In turn, the quality of the monitoring carried out by

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[2] 'Persons professionally arranging or executing transactions' means a person professional engaged in the reception and transmission of order for, or in the execution of transactions in financial instruments.
[3] For a non-exhaustive list of indicators of manipulative behaviour relating to false or misleading signals and to price securing, please refer to Annex I of MAR.

the investment firms could be adversely affected, leading to potentially suspicious behaviour not being highlighted. Following the onsite compliance meetings, it appeared that typically, investment firms held a manual system to monitor the orders and trades. Most investment firms stated that they were not in a position to have automated surveillance systems and were concerned that automated systems would be very costly and unreasonable when considering the relatively low volume of trades which they executed.

In this respect, it should be noted that in accordance with Article 2(5) of Delegated Regulation (EU) 2016/957, arrangements, systems and procedures need to be appropriate and proportionate in relation to the scale, size and nature of the investment firm's business activity. Therefore, in the absence of automated surveillance systems, investment firms should still have alternative arrangements and procedures which are adequate and effective, albeit proportionate to their business activity. Additionally, arrangements, systems and procedures should be:

i. regularly assessed, at least through an annually conducted audit and internal review, and updated when necessary;
ii. clearly documented in writing, including any changes or updates to them, for the purposes of complying with this Regulation, and that the documented information is maintained for a period of five years.

The Authority noted that only few investment firms had executed an audit of the arrangements, systems and procedures. Whereas, some other investment firms planned to undertake the audit within that year, others had never undertaken nor mentioned plans to audit the arrangements, systems and procedures.

It is the investment firms' obligation to ensure that the arrangements, systems and procedures are regularly assessed, particularly, certifying the appropriateness and proportionality of such arrangements, systems and procedures to the scale, size and nature of their business activity.

Furthermore, firms should be able to provide to the Authority with sufficient information to demonstrate the appropriateness and proportionality of their systems in relation to the scale, size and nature of their business activity, including the information on the level of automation put in place in such systems.

With respect to procedures, systems and arrangements to prevent and detect market abuse, investment firms were requested to explain the appropriateness and effectiveness of the same by providing detailed analysis or deep-dives carried out following alerts relating to abnormal trading activity. The Authority is concerned that very few investment firms were in a position to substantiate this with relevant documentation.

Recommended Good Practice
Whilst taking into consideration the size and nature of their business, investment firms are required in accordance with Article 3(4) of Delegated Regulation (EU) 2016/957, to ensure that the arrangements, systems and procedures allow an appropriate level of human analysis in the monitoring, detection and identification of transactions and orders that could constitute insider dealing, market manipulation or attempted insider dealing or market manipulation. A manual or an in-house market monitoring system can, if used appropriately, be an effective surveillance system. The most important aspect of the arrangements, systems and procedures is that such systems, arrangements and procedures operate in an effective manner and that they serve their purpose. Therefore, by way of example, if an investment firm inputs an alert or uses triggers to identify, for instance 'wash trades'[4], proper testing and calibration of the alert parameters and logic should be carried out to ensure that such alert is effectively alerting wash trades and to mitigate false positives. It is extremely important that the monitoring system is able to monitor, prevent and detect both insider dealing and market manipulation. Whereas the majority of investment firms had some controls with respect to the monitoring of insider dealing, these investment firms were lacking with respect to monitoring, preventing and detecting different forms of market manipulation. The Authority has also noticed that some investment firms were also insufficiently expecting to detect insider dealing by simply monitoring their employee's transactions and staff dealing. Whereas we understand that such measures are an important aspect of a firm's surveillance system and procedures, it should be noted that insider dealing arises when a person (irrespective of their employment) possesses inside information and uses that information by acquiring or disposing of financial instruments to which that information relates. On

[4] 'Wash Trade' refers to an acquisition or disposal of a particular security where there is no change in beneficial interest or market risk, or where the transfer of beneficial interest or market risk is only between parties acting in concert or collusion, other than for legitimate reasons.

the other hand, inside information is defined in MAR as information of a precise nature which has not been made public, relating directly or indirectly to one or more issuers or to one or more financial instruments.

Insider dealing includes (but is not limited to):

1. Front running/pre-positioning - transacting on the basis of and ahead of an order (including an order relating to a bid) which a person is to carry out with or for another;
2. Corporate insiders trading in the issuer's financial instruments after learning of significant, confidential developments (i.e. trading ahead of company announcements).

In addition to the above, investment firms are encouraged to consult Annex II of Commission Delegated Regulation (EU) 2016/522 which sets out a list of indicators of manipulative behaviour relating to false or misleading signals and to price securing. Although the list is non-exhaustive, it can well assist the investment firms in determining alerts which can be used to detect different manipulative behaviours.

Arrangements, Systems and Procedures Vis-à-vis Trading in Foreign Securities

Generally, investment firms informed the Authority that the arrangements, systems and procedures in place were used with respect to securities traded on the local market, as in their view, the probability of market abuse arising in foreign-traded securities was minimal. Accordingly, almost all investment firms had no market monitoring processes or procedures in place in order to monitor foreign traded securities.

In this respect, the Authority wishes to clarify that investment firms are required to have in place arrangements, systems and procedures which monitor, prevent and detect insider dealing, market manipulation or attempted insider dealing or market manipulation irrespective of whether the particular security is traded on local or foreign trading venues. Should investment firms suspect abnormal trading activity relating to foreign securities, the MFSA would still expect such firms to raise an STOR.

Submission of STORs

The Authority notes that in general there is under-reporting of suspicious transactions and orders across the market. During the onsite compliance meetings, MFSA officials reminded investment firms that the Authority expects investment firms to submit Suspicious Transactions and Orders Reports ('STORs'), where there is reasonable suspicion that an order or transaction may potentially constitute insider dealing, market manipulation or attempted insider dealing, or market manipulation. The fact that a number of investment firms had never submitted STORs, raises concerns amongst MFSA officials that the systems and arrangements which investment firms have in place could be inadequate and/or ineffective.

Investment firms explained that that they did not want to resort to 'defensive' reporting of STORs. This refers to instances where an investment firm would be unsure whether an activity leads to a reasonable suspicion of financial market abuse, however, adopts a cautious approach and submits an STOR nonetheless. Whilst the Authority acknowledges this view, the MFSA is concerned that investment firms may potentially set high thresholds for the 'reasonable suspicion' test. Investment firms are therefore encouraged to give careful consideration when assessing whether an order or transaction could potentially indicate financial market abuse. Upon receipt of STORs, the MFSA would further investigate the suspicion raised by the respective investment firm in order to determine whether such suspicion is in fact legitimate or otherwise. Accordingly, the submission of an STOR would not automatically imply that there is definitely market abuse.

Investment firms are required to establish and maintain effective arrangements, systems and procedures which facilitates the submission of STORs. Investment firms are expected to perform surveillance across all classes of securities and should raise STORs every time there is reasonable suspicion of market manipulation, insider dealing and unlawful disclosure of inside information.

The transmission of STORs applies to orders and transactions relating to any financial instrument traded on any trading venue (including foreign securities traded on foreign trading venues) and shall apply irrespective of the capacity in which the order is placed or transaction is executed; the types of clients concerned; whether the orders were placed or transactions executed on or outside a trading venue.

In the event that investment firms become aware of any suspicious trading activity relating to the securities listed and traded on a trading venue, it is required to submit an STOR to the MFSA, using the respective STOR template which is made available on the MFSA's website.

For ease of reference, the STOR template can be accessed through the following link.

The Authority has also, on 24 October 2018, issued a circular titled '*Prevention and Detection of Market Abuse by Investment Firms and Trading Venues*' which provides further information with respect to STORs and provides practical examples relating to indicators of market manipulation. The circular, which is available on the MFSA website can be accessed through the following link.

In the event that the investment firms, following their analysis and market monitoring, come to the conclusion that there is no reasonable suspicion to raise an STOR, they are nonetheless required to maintain, for a period of at least five years, the information documenting the analysis carried out with regards to orders and transactions that could constitute insider dealing, market manipulation or attempted insider dealing or market manipulation which have been examined, and the reasons for not submitting an STOR, in accordance with Article 2(1) and (3) of Commission Delegated Regulation (EU) 2016/957.

During the onsite compliance meetings, the Authority was disappointed to discover that only a small number of investment firms retained sufficient documentation of the analysis carried out with regards to orders and transactions. A number of firms held no audit trail evidencing compliance to Article 2(1) and (3) of Commission Delegated Regulation (EU) 2016/957. In these cases, it was very difficult to prove and assess whether the investment firms had effective controls in place for the prevention and detection of market abuse, leading to the eventual submission of STORs to the MFSA or otherwise.

Recommended Good Practice

Investment firms may wish to consider undertaking a detailed assessment of the market abuse risks to which they are exposed, before adopting systems and arrangements to carry out their market surveillance. Taking into consideration the element of proportionality, the size and nature of the investment firm's business may indicate that its systems and arrangements need not necessarily be automated. Depending on the size of the firm, and the process in which orders are obtained and executed, an investment firm could carry out manual market monitoring, which should nevertheless be effective in preventing and detecting market abuse.

It may also be beneficial for investment firms to utilise the experience and market intelligence of front office personnel in the design of this risk assessment, considering that front office staff deal first-hand with investors. Undertaking such assessment could not only assist investment firms in understanding the areas where they need to focus to prevent and detect financial market abuse, but also to ensure that surveillance is proportionate and appropriate whilst highlighting existing gaps which might require further development.

As abovementioned, some of the investment firms maintained for a period of five years, the information documenting the analysis carried out with regards to orders and transactions that could constitute market abuse, which had been examined and the reasons for not submitting an STOR. In particular, such firms held reports documenting analysis in different securities across different time periods, depending on the volume of trading in each security. For instance, a security which had relatively low trading carried out covered a longer time period, typically one year, whereas other securities which involved relatively higher volume of trading carried out analysis more frequent, and generally such analysis assessed trading in a specific security over a quarter, month, etc.

Such investment firms also assessed the investors' trading history, cross-referencing it to the market news and company announcements which were issued with respect to the particular security in which the trading took place. At the end of the analysis, the particular investment firm also specified reasons why it believed that an STOR was merited or otherwise.

For investment firms to prove their adherence to the requirements emanating from MAR, firms should be able to provide to the Authority with sufficient information to demonstrate the appropriateness and proportionality of their systems in relation to the scale, size and nature of their business activity, including the information on the level of automation put in place in such systems. Furthermore, the Authority cannot stress enough how important it is for investment firms to retain sufficient documentation of the analysis carried out with regards to orders and transactions.

Staff Training

Persons professionally arranging or executing transactions are required to organise and provide effective and comprehensive training to the staff involved in the monitoring, detection and identification of orders and transactions that could constitute insider dealing, market manipulation or attempted insider dealing or market manipulation, including the staff involved in the processing of orders and transactions. Such training shall take place on a regular basis and shall be appropriate and proportionate in relation to the scale, size and nature of the business.

We noted that in a number of investment firms, staff training was not given the necessary importance. This led to employees who would be involved first-hand in the handling of orders and transactions, as well as those involved in the post-trade analysis of data, to have a low level of expertise and insufficient knowledge on the prevention and detection of financial market abuse. Investment firms generally conducted a training session to the employees involved in trading and compliance. Some of these firms conducted in-house training, whereas others offered opportunities to their employees to attend training sessions organised by local training institutions or otherwise provided training to their employees through an e-learning platform.

Across the board, it however transpired that investment firms have under-invested in training relating to market abuse. The documentation provided to the Authority with respect to market abuse in-house training carried out shows that, whilst most investment firms offer a good explanation vis-à-vis the legal framework relating to the Market Abuse Regulation, the training offered lacks practical examples and technicality from an operational aspect, in relation to what constitutes market abuse. This implied that the majority of investment firms did not ensure that employees had sufficient knowledge and expertise to detect suspicious orders and transactions.

Firms should also take into consideration the frequency and quality of training on market abuse, and where appropriate, make improvements to ensure staff knowledge is sufficiently up-to-date, for the firm to effectively identify, manage and monitor the risk of market abuse.

Linked to staff training are the processes used to escalate reports of suspicious orders or trades. During onsite compliance meetings, the Authority noticed that in a number of firms, employees were not made aware of the process to escalate suspicious orders and transactions. In other investment firms, the escalation was excessively formalised. It is therefore recommended that investment firms have in place internal processes and procedures which are clear and *inter alia* facilitate the escalation of issues to the compliance team, to for instance assess whether an STOR is merited or otherwise.

Recommended Good Practice
It is recommended that investment firms include market abuse training as part of their training programmes. New recruits should be provided with adequate training, followed by annual training sessions open to all employees. Furthermore, any investment firms considering implementing e-learning platforms, should complement this with face-to-face training as it encourages discussion with respect to real life scenarios, whilst ensuring full understanding of how market abuse regulation applies in practice. It would also be fruitful for investment firms to use practical examples in their training.

Staff Dealing

As aforementioned, staff dealing could lead to market abuse. To minimise the risk that staff dealing may result in market abuse including insider dealing, investment firms should have appropriate rules and staff dealing policies in place. Having a staff dealing policy in place would also ensure that there is no conflict between employees' personal interest and their regulatory obligation to submit STORs.

Typically, most of the investment firms had a staff dealing policy in place. Most staff dealing policies implemented in investment firms required employees to notify transactions to a designated officer and obtaining prior approval. One specific investment firm required its employees to fill in a declaration form in order to inform the respective company of all personal accounts which they hold. The same investment firm also kept record of all transactions carried out by its employees and periodically a report would be issued and presented to the firm's compliance committee.

Recommended Good Practice
Having staff dealing policies in place is a basic control which the Authority recommends all investment firms to have. Although the Authority appreciates the imposition of trading restrictions where applicable and/or the requirement to obtain prior approval, we also recommend that the investment firm carries out additional post-trade review to effectively monitor staff dealing.

Investment Recommendations

In accordance with Article 20 of MAR, persons who produce or disseminate investment recommendations or other information recommending or suggesting an investment strategy are required to take reasonable care to ensure that such information is objectively presented, and to disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates. Supplementing Article 20 of MAR is Commission Delegated Regulation (EU) 2016/958 which lays down the technical arrangements for objective presentation of investment recommendations or other information recommending or suggesting an investment strategy and for disclosure of interests or indications of conflicts of interest.

Generally, investment firms had an investment research policy in place to ensure that the investment research team presents objective information and recommendations to investors. Nonetheless, a number of investment firms did not hold procedures taking into account the requirements of MAR and the respective delegated regulations, with respect to the drafting and presentation of investment recommendations.

The Authority noted that adherence to the requirements of MAR relating to investment recommendations was relatively weak. Consequently, we recommend that investment firms look into such investment recommendations requirements emanating from the MAR regime and ensure that such are incorporated into their procedures and fully abided with.

Concluding Remarks

The findings and 'good practice' recommendations put forward in this circular, reflect the individual feedback which the Authority has provided to all investment firms included in the thematic review, following the respective compliance meetings.

In conclusion, the Authority expects investment firms to ensure that their systems are in constant evolution to meet the changing nature and needs of the businesses within which they operate, including evolving regulatory demands. With the availability of automated surveillance systems in the market, the MFSA expects that if investment firms choose to opt for a manual market monitoring system, such system should be properly documented and should nevertheless allow the firm to provide the Authority with adequate information substantiating adherence to the requirements of MAR. A simple procedure without further documentation showing the actual market monitoring conducted by investment firms would not be deemed acceptable.

Given that the Regulation has been into force since 2016, and taking into consideration the number of onsite compliance meetings held with market participants and the MFSA circulars issued to the industry, the Authority now expects firms to be compliant with all the applicable requirements under MAR.

As a way **forward, it is now the Authority's intention to proceed with carrying out onsite inspections** (rather than onsite compliance meetings), whereby entities would be required and expected to prove proper and full adherence to the respective requirements emanating from MAR and its delegated and implementing regulations.

A breach of the requirements emanating from MAR would warrant regulatory action in terms of Article 22 of the Prevention of Financial Market Abuse Act, Chapter 476 of the Laws of Malta.