FSR OUTLOOK 2021: MAINTAINING MARKET INTEGRITY IN THE TIME OF COVID-19

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Guides

Maintaining market integrity and the orderly functioning of markets is of critical importance to economic recovery, and therefore a key area of regulatory focus. In 2021 we expect to see regulators testing firms' and issuers' market abuse risk management systems, and whether they are able effectively to monitor employees working from home to prevent and detect market abuse. As regulatory forbearance wanes, supervisory and enforcement action is likely to follow; greater access to data and enhanced analytics is making detection of market abuse easier for regulators, and responding to information requests more challenging for firms.

In a nutshell:
- **Maintaining market integrity is key to the economic recovery**
- **Regulators will be testing firms' and issuers' risk management arrangements and controls**
- **Post-crisis supervisory and enforcement action is to be expected**
- **Greater regulatory access to data and enhanced analytics are raising the ante for firms**

IMMEDIATE RESPONSES

Globally, the immediate regulatory response to the pandemic was swift. In the US, the Securities and Exchange Commission (**SEC**) communicated actively with market participants, warning of increased access to new material non-public information as market conditions changed rapidly, and stressing the importance of established disclosure controls and procedures. From February 2020, the SEC also began suspending trading in the securities of companies making questionable claims about having developed treatments for the coronavirus. In March, it set up a Coronavirus Steering Committee to coordinate its Covid-19-related enforcement actions.

In the UK, the EU, Hong Kong, Singapore and Australia too, the regulators quickly identified the likely consequences of the pandemic for the fundamentals, prospects and financial situation of issuers, the potential for delays in the provision of financial information, and a likely need for additional work to support audit opinions and potentially modified audit opinions. Regulators offered issuers a degree of forbearance in respect of the timing and content of financial information, and reached out proactively to corporates in more highly affected industries, issuing a swathe of guidance on the identification and control of inside information (including "new" forms of inside information about matters such as access to government support), on maintaining effective decision making and control environments and striving for consistency in key forward-looking judgments, and on the approach banks, building societies and systemically important investment firms should take in assessing expected loss provisions. Like many others, the Hong Kong Stock Exchange advised market participants of the need for operational readiness during the pandemic. The Monetary Authority of Singapore (**MAS**) and the Australian Securities and Investments Commission (**ASIC**) announced they were deferring onsite supervisory programmes for market intermediaries in favour of desk-based reviews focussing on conduct and resilience during the pandemic.

In these dynamic circumstances, corporate insiders are regularly learning new material non-public information that may hold an even greater value than under normal circumstances."

- Stephanie Avakian, SEC

Regulated firms themselves had to adapt the way they delivered their important business services very rapidly. Those changes required updated risk assessments and adjustments to be made to firms' surveillance systems and to control-monitoring, as the second and third lines of defence still need to be able to carry out detailed reviews.

Regulators expect firms to have equivalent systems for monitoring at home and in the office, to have refreshed training and to have rigorous oversight of the new ways of working. Concern remains about an increased risk of personal dealing as work continues without any physical oversight, and about the use of unsupervised communication platforms. Effective culture of course plays a key role in managing market abuse risks: firms will be considering how most effectively to reinforce their expectations of conduct for remote workers and make clear what can be done "from home", and what technology may be used. Firms should proactively be reviewing their risk management assessments, given that these changes in working practices seem likely to persist. Any changes to the calibration of their surveillance should be subject to appropriate consideration and governance, and carefully documented.

WHAT'S NEXT?

Firms can expect that over the coming year regulators will wish to review, and test, the effectiveness of the arrangements put in place, and firms' monitoring of both office and working from home arrangements. It is important to recognise that a brief period of regulatory forbearance does not mean that standards have been lowered: as Julia Hoggett (FCA Director of Market Oversight) stressed, "regulatory obligations have not changed, the how may be changing, but the what remains the same". Now that initial crisis management measures are in place, firms and listed companies face the prospect of having their actions assessed, potentially through the uncompromising lens of hindsight. We are already seeing some early indications of this.

Regulatory obligations have not changed, the how may be changing, but the what remains the same"

- Julia Hoggett, FCA

In the US, the SEC is actively reviewing companies' disclosures to identify whether Covid-19 has been used to hide previously undisclosed weaknesses; it has opened more than 150 new coronavirus-related inquiries and investigations, following receipt of over 1600 tips, complaints and referrals (71% up on the same period last year). The UK Financial Conduct Authority (**FCA**)'s most recent Primary Market bulletin flags some potential issues with delayed disclosure of inside information, notably around unscheduled financial information and director/board changes, and in reporting the delay to the regulator. With the scale of primary market activity now taking place, and urgent issuer need for refinancing, we are also seeing signs of regulators hardening their stance on whether firms can appropriately manage conflicts of interest in such situations, challenging the effectiveness of wall-crossing arrangements, and demonstrating a willingness to intervene in ongoing transactions.

The pandemic does not of course furnish the regulators with a basis for departing from due process. However, whilst during lockdown criminal investigations face some additional logistical challenges, a slight reduction in the number of open investigations in the UK or elsewhere should not be seen as representing any change in overall regulatory approach.

Significantly increased access to trade and order data, particularly in the EU and the UK, together with the availability of enhanced analytics and more sophisticated use of artificial intelligence, are making it easier for regulators to identify anomalous trading. The FCA identified potentially manipulative behaviours in the *Abbatista* case by running surveillance algorithms across order data from leading UK trading venues. In the US, the Commodity Futures Trading Commission (**CFTC**) said openly that there are cases they simply could not have brought without the data analytics program they now have. In Singapore, MAS is working with market experts and legal professionals to further validate its own augmented intelligence system, Apollo.

Reflecting this trend, we expect to see increasingly sweeping requests for information, and regulators increasingly wanting access to unfiltered data to do the initial sifting themselves. Financial institutions then have little ability to assess whether the information being analysed is reasonably relevant for the purposes of the investigation for which the data was requested. There is an obvious risk that other (unrelated) matters may be uncovered; firms should in any event take steps to ensure that privilege is not inadvertently waived.

Through analysis of market data, we can identify trading patterns that reveal unlawful conduct. I expect, going forward, we will use this type of data analysis across a range of trading activity to detect and punish various forms of misconduct."

- James McDonald, CFTC

2021 will also bring some further changes to the regulation of market conduct. In the UK, the maximum penalty for criminal market abuse offences is set to rise to 10 years. In the EU, the European Commission will put forward draft legislation to implement changes to the regime proposed by the European Securities and Markets Authority (**ESMA**) in the planned review of the Market Abuse Regulation. ASIC may also publish a number of reports, deferred during the pandemic, to deal with new market integrity rules of technology and operational risk for market operators and participants, allocation practices in DCM markets, automated order processing controls for futures market participants, and on dark liquidity, market making, market data access and fees. We also expect MAS' report on proposed requirements on financial institutions aimed at improving controls and facilitating investigations into cases of market abuse.

Two anticipated decisions from the European Court of Justice may have an impact on the enforcement of market abuse in Europe. The first considers whether a journalist's disclosure of information about a forthcoming article discussing a market rumour, and referring to the price of a public takeover bid, could be considered "precise" and thus inside information (a journalistic extension of the star analyst conundrum), and if so, whether the disclosure was made legitimately in the normal exercise of the journalist's profession. The second will review the lawfulness of French laws requiring electronic communications operators to retain connection data on a temporary but general basis to enable that data to be required in the event of suspected market abuse, and could impact how enforcement is undertaken.

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