



Day Four – Nabarro LLP views on the second part of the scenario

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It is 09.30 on Tuesday morning and you are now relatively certain that at least one employee (Rich Mann) has been involved in behaviour that may be considered a form of market abuse.

However, you are uncertain as to:

- exactly what has been going on;
- how long such behaviour has been continuing;
- who at Big Bank may be involved; and
- why such behaviour was not picked up by the existing internal procedures and systems.

You have not reported the matter to the FSA or to Senior Management at Big Bank because up to this point you have not been certain of exactly what has happened.

1. What matters need to be considered when planning a full investigation?

The Law

It is important to have a clear idea of what you suspect the wrongdoing is at an early stage. In this scenario there are a few possible market abuse offences that may have been committed by one or more individuals.

These include:

- *Manipulating transactions.* Behaviour which consists of effecting transactions or orders to trade otherwise than for legitimate reasons and in conformity with accepted market practices which give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of investments, or secure the price of one or more such investments at an abnormal or artificial level.

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- *Employing fictitious devices.* For example, 'pump and dump' or 'trash and cash' type behaviour.
- *Giving false or misleading impressions.* Any other behaviour which is likely to give the regular user a false or misleading impression as to the supply of, or demand for, or the price or value of investments or is likely to distort the market.
- *Other offences.* For example, insider dealing, disseminating false or misleading information or misuse of information, are all possible and therefore an open mind should always be maintained in this regard.

The first and last of these offences are of particular interest because the FSA has recently published Market Watch 33 which considers "*Manipulation of the order book – layering or spoofing*". The FSA state that it believes that this behaviour could constitute market abuse (manipulating transactions) under s118(5) or market abuse (misleading behaviour/distortion) under s118(8) of the Financial Services and Markets Act.

The above offences concern the behaviour of individuals. However, in the light of the possible systems and control problems facing Big Bank, consideration should be given as to the extent to which the following FSA General Principles may have been breached:

- *2. Skill, care and diligence:* A firm must conduct its business with due skill, care and diligence.
- *3. Management and control:* A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- *5. Market conduct:* A firm must observe proper standards of market conduct.
- *11. Relations with regulators:* A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Additionally, and more specifically, Big Bank should consider how its control environment lives up to the requirements in the FSA's SYSC Sourcebook. Although such reviews are likely to be time consuming, some respondents suggested conducting a review of Big Bank's recent trades which have produced large returns (i.e. review traded price against last traded price) to get a crude idea as to how deep such problems may run.

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Terms of reference / project team

Some organisations will have pre written explicit terms of reference for conducting such investigations. Where such procedures exist they should be followed. At an early stage the timeline for the investigation should be made clear. Many respondents commented that the investigation must be thorough, but not overly protracted.

A project team should be established and all information should be channelled through a single person (this person being the most likely person to speak to the FSA from the outset) who will advise Senior Management and /or the Board.

It is important to consider the extent to which persons involved in the project team have the authority required to investigate and to deal with employees. Consideration should also be given to the extent to which HR should be involved at this early stage. Further, consideration must be given as to the extent to which members of the project team are involved in the matters under discussion. Does this mean that Chris Newby, Steve Hart and possibly also yourself (given possible previous lapses) should not be directly involved with conducting the investigation?

Internally, how many people need to be aware of the investigation and what criteria should be used to decide who should know?

The use of external legal counsel should be considered (see also "documentary privilege" as considered in the Day 2 notes). Thought should also be given as to whether the matter is of such importance that different lawyers should be engaged. There is a risk that your existing lawyers who designed your compliance environment may not be entirely impartial.

There have been instances where the FSA did not "believe" typed transcripts of interviews produced by external legal counsel. Consequently, FSA asked to see the original handwritten versions. There is a balance to instructing fresh legal counsel. On the one hand, firms want to employ lawyers that they know and trust. On the other hand this may compromise credibility (were they involved in establishing the regulatory environment in the first place?). "New" external counsel may add credibility.

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In this scenario, as with many regulatory crises, there are potential two investigations that should be conducted:

- an investigation into the trading practices of Rich Mann; and
- an investigation into possible systems and controls failings at Big Bank.

There is a greater need for independence in relation to the systems and controls failings. This is because the Compliance department (and possibly also Operations) might be criticised for not spotting a problem (or potential problem) sooner given the information and warning signs that appear to have existed. As well as considering the need to appoint lawyers, it is sensible to consider providing the project team with access to non-executive board members to allow greater independence, especially where there is the possibility of Senior Management failings.

Information gathering and protection

As was the case when the problem was first spotted, the IT Department will be primarily responsible for retrieving and protecting information. IT will need to ensure that as far as is possible information can not be destroyed or manipulated. As some respondents pointed out, incidents such as these (especially those involving rogue traders or poor control environments) are now a "hot topic" as far as the press is concerned, and therefore information protection is of paramount importance.

At this stage the documents that the project team may consider might just be limited to data records. However this will be dependent on what is found. It is just as important to ensure that where possible new documentation is not produced and that all investigatory documentation is password protected.

All information sources should be considered (such as the personnel records of people involved, all financial records, limit and breach reports, risk reports, relevant spreadsheets, computer records and data, transaction reports, relevant message boards and all archived data). Where possible,

Can the relevant evidence be gathered without compromising confidentiality? If not, what warning should be given to individuals involved in the collection of evidence, or who become aware of the exercise?

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emails and other documentation contained in the employee's home areas should be preserved. This may require speedy applications for legal injunctions.

There may be European Convention on Human Rights Article 8 (right to respect for privacy) issues with contemporaneous information gathering e.g. taping calls and intercepting emails without consent. If such action is provided for in the employment contract or employee manual and falls within the "Lawful Business Practice Regulations" then it should be acceptable. The routine monitoring and recording of communications without consent may be a breach of the Data Protection Act.

2. Consider the action to be taken in relation to any individuals at this point in time

Short-term issues

The respondents' answers in relation to Mann greatly varied. Many suggested that Mann should be immediately suspended (placed on gardening leave), whilst others suggested he should be immediately "interrogated"! Further, lots of respondents suggested that for the moment Mann's trading should be monitored, and that in the short term Steve Hart should be the person interviewed.

In the given scenario Rich Mann is currently on the trading floor. This leads to the possibility that he could continue to carry out similar activity to that already identified.

Any interview should only be conducted when the facts have become clearer. Simply removing Rich Mann from the floor is not an easy decision to make particularly because trading floors are very visible places. Removing him from the floor may have undesirable consequences by putting others on notice of a problem which may cause rumours to flow (making it harder to control the investigation), or allow others to attempt to tamper with evidence. Alternatively, it may not matter if other individuals know that an investigation is taking place and information is being gathered.

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Accordingly, at this stage (09.30) it seems prudent that Rich Mann's activities are closely monitored, possibly until the end of the day when he can be interviewed.

As has been noted above, Steve Hart's position is slightly unclear. In the given scenario he is Rich Mann's line manager and is already on notice as to a possible problem. Therefore, it seems sensible that he is consulted or interviewed as soon as is possible although it is probably preferable that he is not a member of the project team. Additionally, being the head of the trading desk, he is possibly best placed to provide specialist skills in relation to explaining Rich Mann's trading patterns (assuming that Big Bank is comfortable that Steve Hart has himself acted honestly).

FSA have been known to ask for the original handwritten notes of interviews, so take care in writing them and in writing them up!

Interviews

Where a firm may conduct interviews, it is always important to consider:

- Who is going to interview the person(s)? Is there any advantage to using an external investigator and should members of Senior Management or HR be present?
- What is the purpose of the interview? Is it to obtain the individual's story, their credibility or a cross examination in relation to facts which you have at your disposal? Accordingly, is the interview to be conducted under caution? Is it possible that the evidence might be used in a criminal investigation? If so, should the interviewee have separate legal representation and be warned about privilege against self incrimination?
- What order should people be interviewed in? In the given scenario is there any advantage in interviewing Rich Mann and Steve Hart at the same time?

At the early stages any investigation is probably going to take place for investigatory purposes. However, the interviewee should be warned at the outset of the seriousness of the discussion and offered the opportunity to postpone until represented, or to not to talk to you at all.

Any interview should always be conducted in accordance with the firm's internal disciplinary procedure.



3. What third parties should Big Bank consider speaking to?

The FSA

At some stage the FSA are going to have to be notified, however, this should only be once you have sufficient information. You should aim to satisfy the FSA you have:

- adequately identified the problem and the extent of it
- comprehensively investigated and analysed it
- proposed a course of action to deal with the problems (both employee related and in relation to internal controls and procedures)

We worked with a client who delayed notifying the FSA of a problem pending what the client hoped was final resolution. The delay dragged on and resolution always seemed only a day or two away. Eventually, a whistleblower contacted the FSA.

It is important to ensure you don't mislead the FSA by making a knee jerk notification. You should also be aware that the FSA do have the power to intervene and require a "skilled person report."

Dependant on the facts of any investigation notifications to SOCA may also be necessary. Respondents pointed out that in this scenario, where you suspect that a trader may have manipulated the market, consideration should be given as to whether Big Bank are in possession of illegal proceeds which would be a very sensitive matter for banks to consider.

Other regulated entities

In this scenario Lax Securities appear to be facing similar issues to those facing Big Bank (although Lax Securities may not know that this at this stage). Many respondents suggested that Lax Securities should be contacted. Generally speaking there is no obligation for an authorised firm to inform another authorised firm of suspected market abuse being carried out by the other firm's employee (or of another FSA rule breach). It is normal for such matters to be kept confidential until you have a good idea as to what the facts are and where

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the investigation is likely heading. However, where information is needed (in order that you may properly carry out your investigation) then the other firm may be contacted. Respondents commented that all trades involving Lax Securities (and David Sligh) should be reviewed.

It is likely that the FSA themselves will contact Lax Securities once they are satisfied of the facts and therefore it would be unusual for Big Bank and Lax Securities to have direct contact with each other prior to specific FSA involvement with both entities. Where you suspect that the other regulated entity may be facing a substantial problem of which they are not aware (for example a liquidity problem which may mean counterparties will not wish to deal with them) this should be communicated to the FSA as soon as is possible. Additionally, it should be noted that in such instances this knowledge may be considered to be inside information concerning Lax Securities.

Insurers

There is a good possibility that Big Bank's insurance contract requires them to keep their insurers informed on a full and frank basis. Although not relevant in this fact pattern, where you feel you may have a potential insurance claim the insurers should be notified at the earliest opportunity.

Clients

In the given scenario it is not immediately apparent that Big Bank's clients will be directly affected, however, some regulatory crises have the potential to do so. In some cases it may be appropriate or even required (under the FSA rules) for the firm to notify its clients of the incident (though certainly not before the FSA have been notified). It should be noted that an entity has purchased the ABZ Resources shares at an inflated price. Although the purchaser is not a client of Big Bank they may have a possible claim in relation to the inflated price paid.

We are aware of a case where an entity thought they were likely to be disciplined by the FSA on a matter, but expected the enforcement investigation and final notice to take six months to come out. The original plan was to talk to their PR representatives shortly before that date. However, the matter was leaked without a PR strategy being in place.

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PR/ Press

It may be appropriate to brief internal or external PR in order to develop a strategy. It will usually be appropriate to have a PR line for when the FSA issue any final disciplinary action. Further consideration should be given as to whether you need a holding strategy in meantime (when either the rumours or the extent of the problem become public) while awaiting the final FSA outcome.

4. Are there any other issues that you would consider?

Internal systems and controls

It is unlikely in this case that the FSA would require a "s166 investigation". In such instances firms should nevertheless conduct a full review of relevant internal systems and controls, once the initial "regulatory storm" has died down. The FSA will expect that such internal review would demonstrate that:

- senior management are actively involved in this review
- the project team is sufficiently skilled to carry out the investigation
- the investigation is full in terms of time scope, areas of the business and individuals involved
- ongoing business will not be affected as a result of the investigation
- sufficient stop gap measures have been introduced in order that similar problems can not occur in the interim, while the more detailed systems and controls review is being carried out

In some instances it may not be necessary to contact the FSA at all as it may not have constituted a big enough regulatory breach. Where this is the case, it is nevertheless important that the problems identified in the investigation are documented and adequately addressed. Some of the largest recent FSA fines have come where firms have identified problems, but have failed to follow them up appropriately.