

A blue-toned background image featuring a financial line chart with multiple data series and a grid. The chart shows various trends, including a sharp decline followed by a recovery and another decline.

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7 March 2018

Financial Regulation Monthly Breakfast Seminar

Overview





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The FCA report on controls around
algo trading
Becky Critchley

The FCA sets expectations on algorithmic trading

- The FCA has published a report which sets out the key areas of focus for algorithmic trading compliance in wholesale markets
- Highlights good and poor practice observed ahead of the implementation of MiFID II
- Greater focus of the report is larger firms that develop algorithmic trading strategies themselves
 - However, relevant to all firms that develop and/or use algorithms
- The obligations under RTS 6 prompted many questions - particularly in relation to the role of compliance, the kill functionality, and the post-trade controls required for risk management

How did we get here?

No specific rules under MiFID I

ESMA Guidelines on Systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities
(February 2012)

MiFID II addresses pace of change and defines algorithmic trading and high frequency trading (HFT)

Articles 17 and 28 of MiFID II
(see also Recitals 59 to 68)
+
RTS 6
(Delegated Regulation 2017/589)
+
FCA report on Algorithmic trading compliance in wholesale markets
(February 2018)

Five key areas of focus

The FCA has identified five key areas of focus, and outlined some useful examples of what it considers to be good and poor practice in relation to each of these areas:

1. Defining what constitutes algorithmic trading
2. Development and testing of algorithms
3. Risk controls
4. Governance and oversight
5. Market conduct

1. Defining algorithmic trading

FCA expectation

- Firms must establish an appropriate process to identify algorithmic trading, manage material changes, and maintain a comprehensive inventory of algorithmic trading across the business

Good practice

- Firms who conduct extensive reviews (consulting all aspects of the business) to consider at length how trading algorithms are used within the firm and across the whole business

Poor practice

- Firms who don't have clearly defined inventories in place and are only able to provide generic high level descriptions for their algorithms, strategies and systems

2. Development and testing

FCA expectation

- Firms must maintain robust, consistent and well understood development and testing processes that identify potential issues across trading algorithms before full deployment

Good practice

- Firms who have checkpoints throughout the development and testing process (for example, after initial due-diligence was completed, at several stages during testing and prior to full deployment) with a full review at the end of each stage

Poor practice

- Firms who are unable to provide effective MI to senior management on areas such as conformance testing, operational arrangements, pre-trade risk parameters, training and surveillance procedures prior to deployment

3. Risk controls

FCA expectation

- Firms must develop suitable and robust pre-trade and post-trade controls to monitor, identify and reduce potential trading risks across algorithmic trading activity

Good practice

- Firms who maintain detailed controls at multiple levels. For example, by client and/or trading strategy depending on the type of business undertaken, as well as on a firm wide basis

Poor practice

- Firms who do not formally log incidents/breaches and fail to provide MI reports to appropriate forums
- This prevents valuable MI being presented for senior management to identify potential emerging issues and risks

4. Governance and oversight

FCA expectation

- Firms must maintain an appropriate governance and oversight framework that demonstrates effective challenge from senior management, risk management and compliance

Good practice

- Firms where algorithmic trading is fully understood by senior management, who play a key role in providing challenge across the business
- For example, where senior management are involved throughout the development and testing process and actively seek to understand the potential market conduct implications

Poor practice

- Compliance functions who are unable to demonstrate that compliance staff have sufficient technical knowledge to oversee and monitor algorithmic trading activity effectively

5. Market conduct

FCA expectation

- Firms must consider the potential impact of their algorithmic trading on market integrity, monitor for potential conduct issues and reduce market abuse risks

Good practice

- Firms who consider how they can tailor their monitoring and surveillance systems to specific risks within their algorithmic trading activity and also ensure suitable market abuse training is conducted for all relevant members of staff

Poor practice

- Firms who maintain basic market abuse alerts such as insider dealing or layering and spoofing but do not consider other types of market manipulation which can be associated with algorithmic trading



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BAU insights and war stories

David Berman

BAU insight

- Heightened focus on effectiveness of first line of defence
- Demarcation of responsibility between first and second lines
- Importance of 'need-to-know' principle
- Training and awareness: fit for purpose?
- 'Regulation by expectation'
- Conduct risk: meeting regulatory expectations

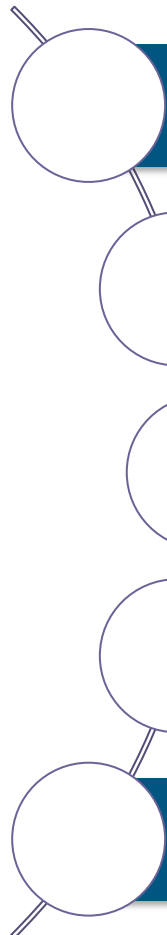
A blue-toned background featuring a financial line chart with multiple data series and a grid. The chart shows various peaks and troughs, typical of stock market data. The overall aesthetic is professional and data-oriented.

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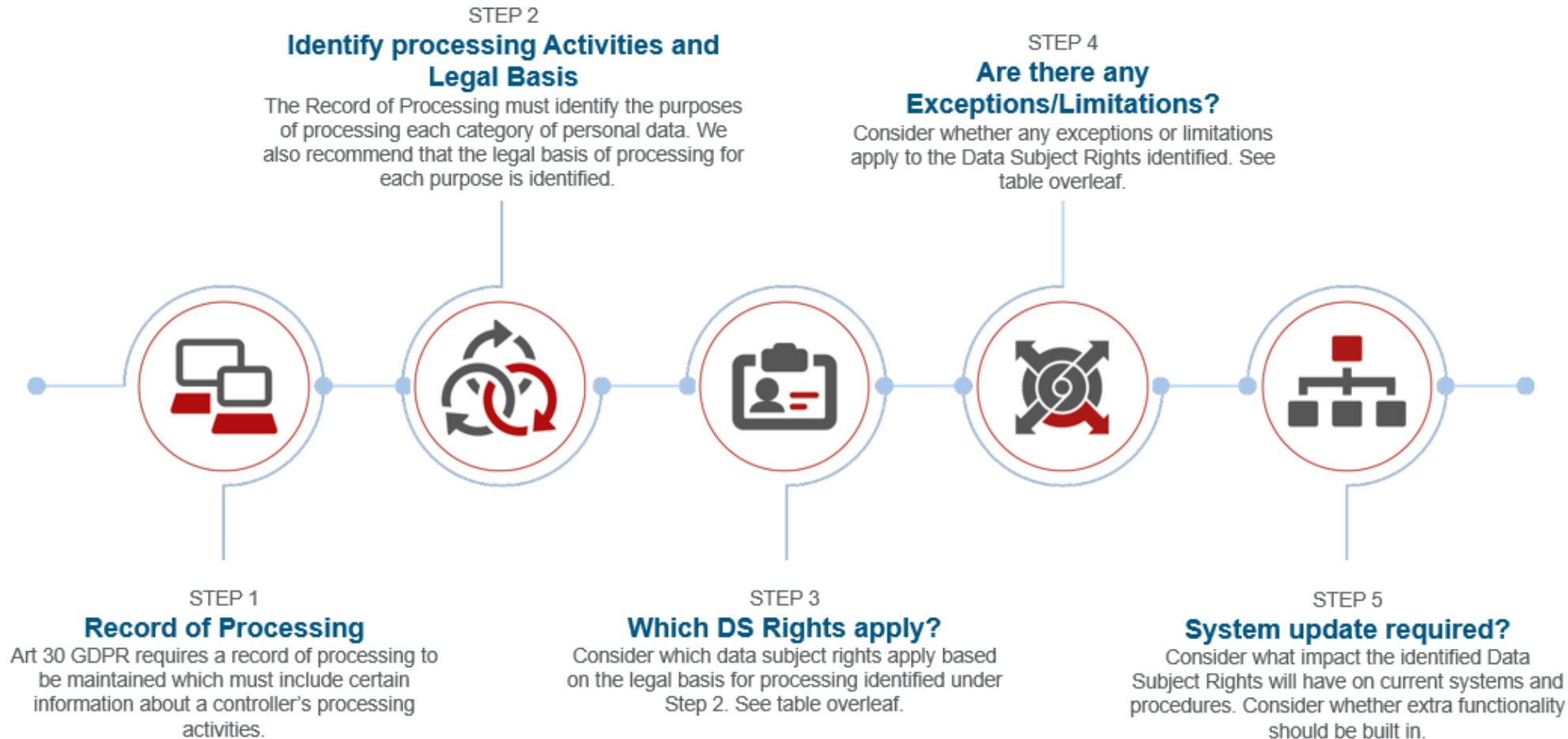
The impact of GDPR on financial institutions

Danielle van der Merwe

GDPR Changes - Is your house in order?

- 
- Record of Processing
 - Update Notices – Art 29 WP Guidance
 - Identify Legal Basis for Processing
 - Which Data Subject Rights apply?
 - Update Incident Response Policy – Art 29 WP Guidance

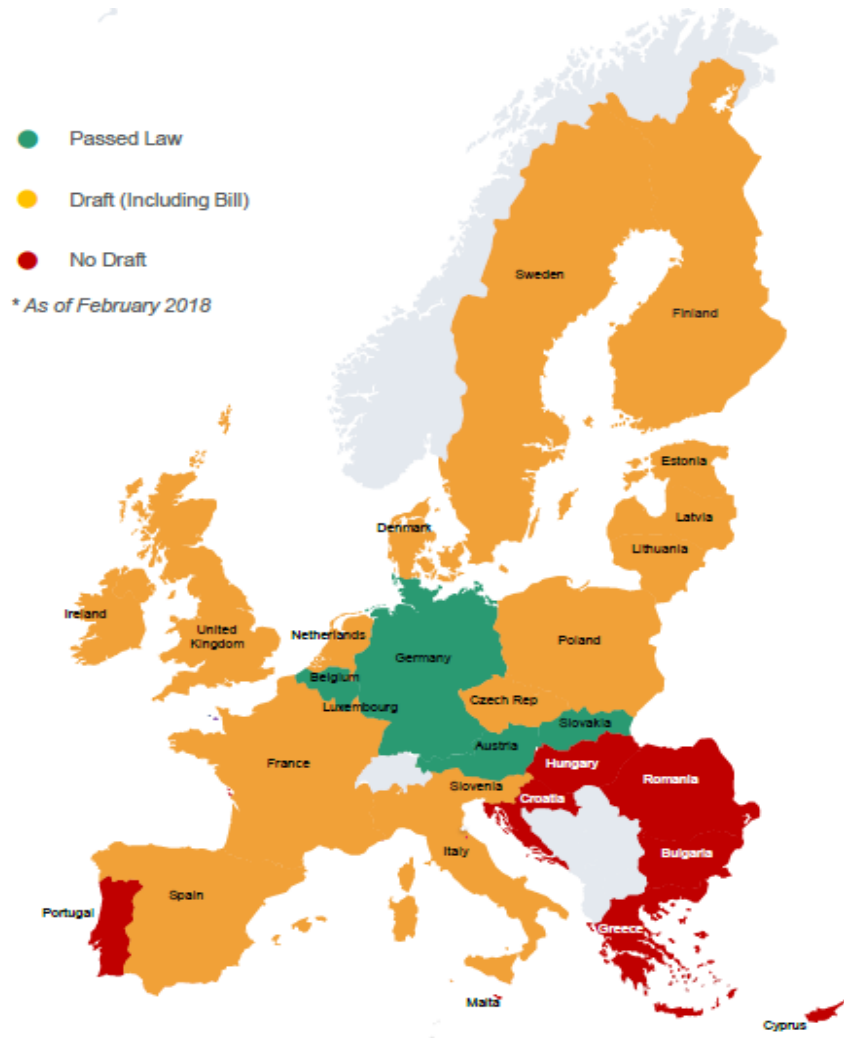
GDPR: 5 Step Flowchart



When do Data Subject Rights apply?

	Consent <i>Art. 6(1)(a) GDPR</i>	Contract <i>Art. 6(1)(b) <u>GDPR</u></i>	Legal obligation <i>Art. 6(1)(c) <u>GDPR</u></i>	Vital interests <i>Art. 6(1)(d) <u>GDPR</u></i>	Public interest <i>Art. 6(1)(e) <u>GDPR</u></i>	Legitimate Interests <i>Art. 6(1)(f) <u>GDPR</u></i>
Access (Art 15 GDPR)	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Rectification (Art 16 GDPR)	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Erasure ('right to be forgotten') (Art 17 GDPR)	<input checked="" type="checkbox"/>					<input checked="" type="checkbox"/>
Restriction of processing (Art 18 GDPR)	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Data portability (Art 20 GDPR)	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>				
Object (Art 21 GDPR)					<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Automated individual decision-making, including profiling (Art 22 GDPR)				<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

GDPR: Status of Local Implementing Law



- 4 Member States (Germany, Austria, Belgium and Slovakia) have successfully implemented GDPR into local law.
- 8 Member States have not published any draft legislation yet.

Privacy Blog:

<https://www.globalprivacyblog.com/>



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FCA's Policy Statement 18/3 – perimeter guidance on personal recommendations

David Berman

Background

- FAMR identified issues regarding access to financial advice and guidance services
- Final report recommended narrowing the definition of regulated advice, and providing guidance to help firms understand the boundary, in order to encourage more firms to provide unregulated guidance services
- Change to the definition of regulated advice took effect from 3 January 2018:
 - For firms that are authorised to carry on any regulated activity other than (or in addition to) advising on investments, the activity of advising on investments only applies to the extent that the firm is providing a ‘personal recommendation’
 - For firms that are not authorised, or that are only authorised to carry on the activity of advising on investments, the original, broader activity of advising on investments continues to apply

PS18/3 changes

- New guidance in PERG took effect 23 February 2018
- FCA has now 'retired' FG15/1 (pre-existing guidance on personal recommendations)
- FCA has also published a consumer guide to explain the differences between advice and guidance on investments
- Main additions to PERG include guidance on when pre-purchase questioning might amount to regulated advice, guidance on the definition of 'personal recommendation', and a collection of illustrative examples

Illustrative examples

- Addition of a new Annex to PERG 8, setting out illustrative examples of what is (and is not) a personal recommendation, or regulated advice
- Examples cover a range of scenarios, including:
 - Different website formats (e.g. websites with or without filtering)
 - Provision of sales guidance
 - Different types of customer communications / provision of information to customers about investments

Illustrative example (1)

Example	Personal recommendation?	Regulated advice?
<p>Firm B ranks the products it sells into risk categories. One set of categories could be Low Risk, Low-Medium Risk, Medium Risk, Medium-High Risk and High Risk. Firm B allocates each investment using its own opinion on the level of risk of each product (i.e. it is self-generated and not drawn directly from each product's disclosure material). For example a list of funds' riskiness based on the firm's analysis and metrics.</p> <p>The website also has material elsewhere explaining investment risk and material to help customers self-determine the level of risk they are willing and able to take. Each risk category description includes notional customer attitudes, the types of investments that may be found within funds/portfolios matching this risk level and also historic factual data on the volatility of such investments. Customers are prompted to read the risk category descriptions and to use this material to think about which category best fits their circumstances.</p>	<p>Not a personal recommendation.</p> <p>The recommendation is not presented as suitable for the customer or based on a consideration of their personal circumstances.</p> <p>The customer reads both sets of information (list of products and explanatory material) and makes any investment decision on that basis.</p>	<p>If the firm is not appropriately authorised this is likely to be regulated advice. Please see the reasons in PERG 8.30A.14G.</p> <p>Although that guidance refers to an Internet-based filtering process, this example is also based on value judgments about the relative merit of specific investments given to someone interested in buying or selling them.</p> <p>As explained in PERG 8.30A.14G(6) classifying products based on risk categories need not be regulated advice outside the sales context.</p>

Illustrative example (2)

Example	Personal recommendation?	Regulated advice?
<p>A firm has a number of its customers that it believes are invested in products that do not align with their needs.</p> <p>The firm contacts those customers to inform them that based on a review of the customers' holdings, the firm believes that the products that they hold may not be suitable for their needs. It explains that:</p> <ul style="list-style-type: none">• the products the customer holds are poorly diversified;• the portfolio of products has underperformed compared to the products' benchmarks; and• the portfolio of products is not suitable for what the firm understands the customer's investment purpose to be (e.g. a high proportion of cash funds in a pension wrapper). <p>The firm invites the customers to contact an adviser with whom the customer may discuss alternative options.</p>	<p>If this does involve regulated advice under column (3) of this example it will also involve a personal recommendation.</p> <p>This is because the communication refers to the customer's individual portfolio and investment purposes.</p> <p>The fact that the communication may in fact be standardised across a large number of customers does not mean that it is not a personal recommendation.</p>	<p>If the firm does not identify either what part of the customer's portfolio should be sold or how the customer should reinvest the proceeds, the firm is giving advice but as that advice does not relate to particular investments it is not regulated advice.</p>



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Questions?