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**BY EMAIL**

21 January 2020

**SECURITIES MARKETS CONDUCT RISK - JANUARY 2020 INDUSTRY COMMUNICATION**

Dear CEO

The Central Bank of Ireland is the national competent authority in Ireland for market conduct supervision under a range of statutory mandates.<sup>1</sup> In March 2019, the Central Bank issued an industry communication (**2019 industry communication**), setting out expectations for the identification, mitigation and management of market conduct risk by regulated financial service providers engaging or applying to engage in wholesale market activity (**regulated entities**).<sup>2</sup>

Financial markets encompass complex interconnected activity, a wide range of financial products and a large, varied group of professional market participants. Those participants include regulated entities and other entities, including all issuers and proposed issuers of financial instruments for which the Central Bank is not the primary regulator but over whom it has supervisory authority under, for example, the Market Abuse Regulation (**MAR**). The importance of financial markets in the context of the Irish financial services sector is underlined by the increase in the scale and sophistication of activity carried on in and from Ireland and by branches of Irish firms in other jurisdictions.

In 2019, the Central Bank employed a range of supervisory tools to assess wholesale market conduct risk, including a thematic review of regulated entities' effectiveness in identifying and assessing such risk. As part of this exercise, the Central Bank engaged directly with 24 regulated entities, conducted on-site inspections of 10 regulated entities and visited branches of Irish entities in other jurisdictions.

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<sup>1</sup> Includes MiFID II, MAR, the Central Bank Reform Act 2010 and, where relevant, the CRD IV regime, the Investment Firm Regulations 2017, EMIR, the Central Securities Depositories Regulation and the Securities Financing Transaction Regulation.

<sup>2</sup> The 2019 industry communication is [here](#).



Central Bank supervisors conducted over 150 interviews of directors and CEOs, risk and compliance officers and frontline staff and the Central Bank continues to engage with relevant entities in relation to identified deficiencies.

The Appendix to this letter describes the key findings arising from that work. The central theme underpinning those findings is that entities may not have been adequately identifying the market conduct risk to which they are exposed, and so cannot appropriately mitigate and manage the risk. That failure leads to or, where relevant, arises from the following:

1. **Inadequate market conduct risk frameworks:** The Central Bank expects regulated entities to fully embed into their organisational arrangements, market conduct risk frameworks and consequential controls that your employees fully understand.
2. **Inadequate governance of market conduct risk:** The Central Bank expects the Board and senior management of regulated entities to take full ownership of the governance of market conduct risk. In the global context this includes challenging group decisions where appropriate. It also means ensuring your entity is sufficiently well controlled to monitor, marshal, receive and, where appropriate, report to the Central Bank all information pertinent to the conduct of your staff and, where relevant, staff located in your affiliate entities. Regulated entities must fully embed compliance with the Central Bank's Fitness and Probity Regime into their organisational arrangements at local and branch level.
3. **Failure to identify the risk of market abuse:** The Central Bank expects regulated entities, issuers and those who act on behalf of issuers (whether or not they are regulated entities) to have systems and controls in place to ensure compliance with their obligations under the Market Abuse Regulation and related legislation. Where relevant, this includes the establishment and maintenance of effective trade surveillance systems and other arrangements to prevent, detect and report potentially abusive behaviour. For issuers and market participants who contact them it includes the implementation of organisational arrangements that minimise the risk of abusive behaviour.

The ability and willingness of market participants to identify and appropriately mitigate and manage market conduct risk is at the heart of trust in securities markets. In light of these findings, the Central Bank expects market participants to place a renewed focus on ensuring they have in place frameworks that effectively protect the best interests of investors and they operate in a fair, orderly and transparent manner.

The Central Bank's supervisory work in 2020 will include focussing on regulated entities' ability to identify market conduct risk; the extent to which they are sufficiently well controlled to govern wholesale market conduct risk; and the flow and escalation of conduct-specific information within and across regulated entities and groups.



The Central Bank also expects to devote considerable supervisory resource in the year ahead to examining the compliance by regulated entities and issuers with their obligations to recognise and manage inside information and, in the case of relevant regulated entities, to identify suspicious transactions and orders.

Please bring this letter to the attention of your Board at its next meeting. Regulated entities should review the expectations set out in the Appendix and address misalignments with their internal frameworks and practices. Issuers to whom this letter is addressed should focus on the relevant concerns expressed in the third finding - failure to identify market abuse risk.

The Central Bank reminds regulated entities of the importance of continued observation of the expectations in the 2019 industry communication and directs the attention of all readers to its [five principles](#) for a proper and effectively regulated securities market.

In circumstances of non-compliance by entities with regulatory requirements relevant to the matters raised in this letter, the Central Bank may, when exercising its supervisory and/or enforcement powers, have regard to the consideration given by an entity to the matters raised in this letter. Please address queries regarding this letter to [wholesaleconduct@centralbank.ie](mailto:wholesaleconduct@centralbank.ie). You are not, however, required to respond to this letter.

Yours sincerely

A handwritten signature in blue ink, reading "Derville Rowland".

**Derville Rowland**

Director General Financial Conduct



## APPENDIX: SECURITIES MARKETS CONDUCT RISK - KEY FINDINGS FROM THE CENTRAL BANK'S 2019 ACTIVITY

### 1. INADEQUATE MARKET CONDUCT RISK FRAMEWORKS

#### Legal and regulatory background

The MiFID regime requires regulated entities to comply with a range of organisational requirements, including implementing policies and procedures that are sufficient to ensure compliance by regulated entities with their obligations under the MiFID regime. Regulated entities must also comply with additional legal and regulatory requirements pertaining to or encompassing securities markets activity. Not least of these is the Central Bank's Fitness and Probity Regime (the **Fitness and Probity Regime**).

The 2019 industry communication stressed the Central Bank's expectation that regulated entities demonstrate and evidence their market conduct risk identification processes.

#### Failure to identify market conduct risk

The Central Bank observed that some regulated entities lacked a structured market conduct risk identification process. The Central Bank also identified instances where entities had a framework to identify market conduct risk but the framework was not fit for purpose and/or did not identify applicable controls to mitigate identified risks. Where controls did exist, there was often insufficient communication of them to employees. There was also inadequate testing of control effectiveness.

The Central Bank observed that centralised group risk management functions often identified market conduct risks and cascaded them to the Irish regulated entity. This approach is acceptable, subject to consideration of the local entity's specific circumstances. But the Central Bank identified numerous failings with this type of group-led approach. This included a failure to capture Irish entity-specific risk in sufficient detail, lack of contribution or challenge by the Irish regulated entity and, in particular, a lack of input from Irish entities' frontline staff.

Many of the risk registers the Central Bank examined referenced conduct risks in a high level, generic way. They were not specific to the regulated entity's risk or its particular business model. During inspections and interviews, some entities could only identify a single, generic conduct risk.

#### Inadequate market conduct risk MI

The Central Bank frequently observed inadequate market conduct-related Management Information (**MI**). Staff in some regulated entities did not have a clear understanding of the MI they should generate and to whom they should send it to facilitate the effective management of this critical risk. The Central Bank also observed a lack of quality assurance undertaken on MI. In some regulated entities, the CEO did not review MI, which went directly to group structures.

#### Lack of staff understanding of market conduct risk

Some staff in regulated entities lacked a basic understanding of what constitutes market conduct risk. They could not identify such risk in their area of responsibility. Others identified controls but could not



explain the underlying risk. This demonstrates regulated entities' failure to embed their market conduct risk frameworks effectively throughout the organisation.

### **Lack of proactive identification of conflicts**

One risk inherent to all regulated entities is conflicts of interest. Regulated entities were aware of this risk but some identified conflicts are on an event driven or reactive basis only.

### **What some regulated entities were doing well**

The Central Bank identified one instance of a regulated entity that had developed a comprehensive and effective market conduct risk framework in line with the 2019 industry communication in an especially proactive manner. That included the completion of a regulatory horizon scanning exercise, which considered conduct risk specific to its business model. This resulted in the design of a bespoke framework with embedded controls to mitigate risks and routinely test control effectiveness. Staff demonstrated an understanding and awareness of the nature and impact of the conduct risk arising from the entity's particular business model.

### **Central Bank expectations**

- Regulated entities should identify all market conduct risks applicable to their business model at local and branch level. Where relevant, this should include engagement with, and challenge to, centralised group risk management functions.
- Regulated entities should use their conduct risk identification process to inform the development of their market conduct risk frameworks and consequential controls.
- Regulated entities should generate and use market conduct-related MI that is relevant, accurate and timely and ensure staff understand what information should be generated, maintained and escalated and to whom. Where entities submit MI to group risk management functions, relevant local senior management should also review it.
- Regulated entities should include the identification of potential conflicts of interest in their conduct risk identification process and implement specific, written, consequential controls.

## **2. INADEQUATE GOVERNANCE OF MARKET CONDUCT RISK**

### **Regulatory background**

The 2019 industry communication requires regulated entities to demonstrate and evidence how market conduct risk management and mitigation is included in the objectives for senior management. It is critical that regulated entities clarify responsibilities and accountabilities for managing and mitigating market conduct risk at Board and executive committee levels.

### **Poor governance of market conduct risk**

The Central Bank observed several cases where senior management (including CEOs) failed to demonstrate an understanding of their entities' market conduct risk frameworks and the impact market conduct risk can have on operations. The Central Bank also observed a lack of regular challenge and oversight by Boards and senior management in relation to market conduct risk.



### **Poor governance in the global context**

In the Irish regulated entities of some global firms, the Central Bank observed instances where, in practice, the CEO did not have autonomy in market conduct risk related decision-making. In some cases, senior staff in Ireland effectively reported on a hard-line basis to management at group level for market conduct purposes. In some global structures, the Central Bank observed poor flow of conduct-related information between branches and affiliates of Irish entities and the Irish entity itself.

### **Poor governance in the context of the Fitness and Probity Regime**

The Central Bank observed some Pre-Approval Controlled Function (PCF) holders were not discharging all of the responsibilities associated with their functions. A particular concern is the role of the Head of Trading (PCF-29). The Central Bank noted a tendency for the PCF-29 to focus almost exclusively on profit generating activity resulting in limited oversight and control (if any) of the activities for which they were responsible.

### **What some regulated entities were doing well**

The management of the regulated entity that demonstrated a mature, embedded market conduct risk framework exhibited ownership of risk and engaged in constructive challenge.

The Central Bank observed that the level of awareness of the Fitness and Probity Regime by managers of branches in other EEA countries (PCF-16) was higher among those managers who had engaged with the Central Bank's 8 April 2019 [Dear CEO](#) letter regarding fitness and probity and the 2019 industry communication.

### **Central Bank expectations**

- The Board and senior management of regulated entities should own the governance of market conduct risk irrespective of group arrangements. In the global context, this includes challenging group decisions and approaches where appropriate.
- Regulated entities should assess their governance structures on a periodic basis to ensure they have sufficient capacity to manage market conduct risk. They should consider the roles, responsibilities and accountabilities of individuals, management committees, internal functions and any entities engaged on an outsourced basis.
- Regulated entities should be sufficiently well controlled to monitor, marshal, receive and, where appropriate, report to the Central Bank all information pertinent to the conduct of its own staff and (where relevant) affiliate staff, irrespective of their location.
- The Central Bank reminds regulated entities of their obligations under Section 21 of the Central Bank Reform Act 2010. These obligations include not only performance of due diligence to ensure controlled function staff (including PCF holders) comply with the Fitness and Probity Standards 2014. Regulated entities are also obliged to satisfy themselves on reasonable grounds and on an ongoing basis of the fitness and probity of such staff, including, where relevant, providing appropriate training. This includes the PCF-29 function.

## **3. FAILURE TO IDENTIFY THE RISK OF MARKET ABUSE**

### **Regulatory background**



Behaviours and practices associated with regulated entities' activities that heighten the risk of market abuse occurring or going undetected constitute a risk to the integrity of the market and to effective governance and compliance by regulated entities. Failures in this area may reflect serious organisational weaknesses that leave entities, their employees, clients, investors and the wider securities market vulnerable to adverse consequences.

### **Inadequate trade surveillance**

The Central Bank identified ineffective MAR<sup>3</sup> trade surveillance in some regulated entities, particularly in relation to how they generate, analyse and close alerts. Oversight of trade surveillance activity outsourced to affiliates and other third parties was often deficient with regulated entities providing insufficient monitoring of, challenge to and supervision of the outsourcee.

### **Inconsistent approaches to Suspicious Transaction and Order Report (STOR) submission**

Some regulated entities adopted a potentially ineffective approach to the submission of Suspicious Transaction and Order Reports (**STOR**). Relevant regulated entities must submit a STOR to the Central Bank where the entity observes an order or transaction that could constitute market abuse. The Central Bank observed inconsistencies in the decision-making processes across regulated entities when it comes to the type of activity that should generate a STOR submission. Some interviewees referenced suspicions about market abuse by others but had not submitted a STOR.

### **Poor quality communications between regulated entities and issuer investor relations functions**

The Central Bank's engagements with some regulated entities raised concerns about the quality of communications between regulated entities and issuer investor relations functions and the extent to which such communications are MAR-compliant. The Central Bank recognises these engagements are a routine element of the functioning of the market. But the Central Bank identified examples where frontline staff may have sought information from issuers without fully considering the extent to which that information might be inside information.

The Central Bank observed misalignments in understanding between compliance and front line functions regarding the controls governing the relationship between regulated entities and issuers.

### **What some regulated entities were doing well**

The quality of the content of STOR submissions to the Central Bank is generally good.

### **Central Bank expectations**

- Regulated entities should assess the effectiveness of their trade surveillance systems on foot of this letter and on a periodic basis. They should take into account the nature and frequency of the data gathered, the extent of review (including the assessment of alerts), and analysis of that data. Regulated entities should seek to strike an appropriate, entity-specific balance

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<sup>3</sup> The Central Bank's concerns go beyond trade surveillance for MAR purposes and include surveillance for other risks, including unusual changes in trader order and execution patterns and adherence to position limits.



between prudent and effective reliance on technology and the application of human judgment and scepticism.

- Where regulated entities outsource trade surveillance functions to third parties, including affiliates, they remain responsible for performance of this activity and should actively monitor and supervise the performance of outsourcees.
- Regulated entities should establish and communicate to staff, clear lines of responsibility for oversight of trade surveillance and internal escalation of alerts.
- Regulated entities should consider whether the quality and volume of their STOR submissions is appropriate given their level of trading activity.
- In the context of their dealings, issuer investor relations functions (whether outsourced or in-house) and market participants who contact them should ensure they do not, respectively, breach the prohibitions against unlawful disclosure of inside information and insider dealing. Regulated entities and issuers should have in place controls governing communications between, for example, research analysts and issuer investor relations functions to minimise the risk of breaching MAR.