



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem



Securities Markets Risk Outlook Report

A Changing Landscape

February 2022

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Foreword

Following on from the publication of our first Securities Markets Risk Outlook Report in 2021, this year's report is designed to inform regulated financial service providers, investors and market participants of the key risks and areas of focus for the Securities and Markets Supervision Directorate (SMSD), which will inform our supervisory engagements in 2022.

We also take the opportunity to set out at a high level our expectations of what regulated financial service providers and market participants should do to effectively identify, mitigate and manage risks in the context of their particular business activities.

The contents of the report will aid securities markets participants to assess the risks they face and inform their risk mitigation planning. We will take appropriate supervisory action in instances where securities market participants have not considered the risks outlined in this report or where we identify behaviour that falls short of our expectations.

We look forward to building on our strong securities markets regulatory framework and working constructively with market participants to deliver on our goal of fair, transparent and efficient securities markets which operate in the best interest of investors.

Patricia Dunne

Director of Securities and Markets Supervision

Introduction

This Risk Outlook Report is published against a backdrop of continued uncertainty due to the ongoing impact of COVID-19 and a marked acceleration in the pace of change underway across securities markets, including changing investor behaviours, technological developments and the transition to a carbon neutral economy.

Throughout the last year, as the economy and markets began to recover, aided by supportive monetary policies and global vaccine programmes, the Central Bank of Ireland (“**Central Bank**”) has continued to monitor securities markets and the behaviour of regulated entities.

While financial markets have demonstrated resilience over this period, vulnerabilities remain as increasing levels of indebtedness, stretched asset values and risk taking behaviour in a search for yield environment have become more prominent.

Our supervisory work programme, which is discussed in more detail in our ‘Year in Review’ section, continued apace in 2021. We have worked to build a strong and flexible authorisation and supervisory framework to deliver on our mandates. That framework has proved to be resilient in the many challenges of the pandemic, including the need for our activities to be undertaken in a largely virtual environment. There are still challenges and uncertainties ahead and firms need to remain proactive and vigilant in their planning and mindful of the risks to investors and themselves.

In 2021, we also continued to implement a growing European legislative pipeline which, among other things, increasingly focuses on the use of regulatory data. Data is an increasingly important element of our regulatory toolkit that allows for the identification of trends and risks and the development of supervisory and gatekeeper work programmes.

This report highlights the key conduct risks we see facing securities markets in 2022, specifically: **Misconduct Risk; Sustainable Finance; Governance; Conflicts of Interest; Financial Innovation; Data; Cyber Security** and **Market Dynamics**. Each of these risks are discussed in subsequent sections.

Our Mission and Principles

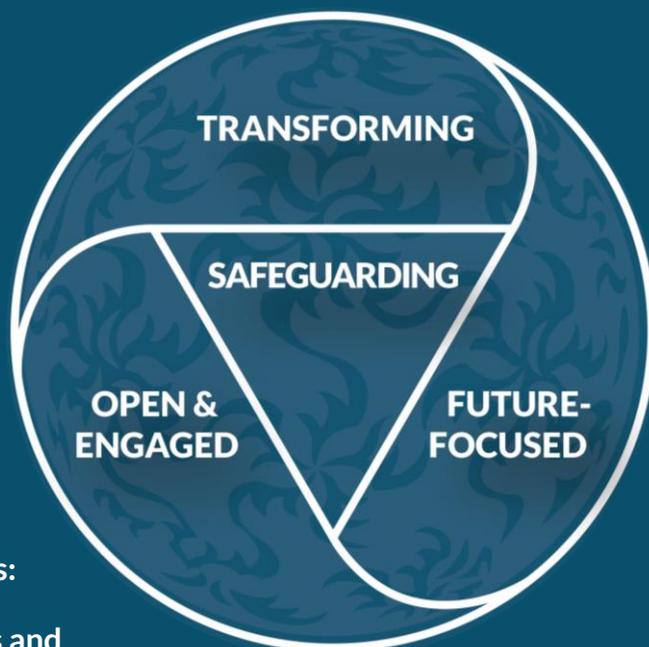
The mission of the Central Bank is to serve the public interest by safeguarding monetary and financial stability and working to ensure that the financial system operates in the best interests of consumers and the wider economy.

Our work in supervising securities markets is a core part of this mission. As we embark on our new [2022-2024 Strategic Cycle](#), our approach to our supervisory and gatekeeper responsibilities in securities markets will continue to evolve in line with our four new Strategic Themes.

In our supervision of securities markets we are looking to see a market that satisfies five principles:

- It has a high level of protection for investors and market participants.
- It is transparent as to the features of products and their market price.
- The market must be well governed and comprise firms that are well governed.
- The market must be trusted, by both those using the market to raise funds and those seeking to invest.
- The market must be resilient enough to continue to operate its core functions in stressed conditions and to innovate appropriately as markets evolve.

We expect firms to have regard for these principles when conducting their business and take all necessary steps to ensure they contribute to the achievement of a securities market that adheres to these principles.



2021: Year in Review

In this section, we give a brief outline of some of the developments that took place in 2021 following the publication of last year's report.

One of our core principles is that securities markets have a high level of **protection** for investors and market participants. To advance this, we further embedded our ROBUST Gatekeeper Principles, outlined in last year's report, by applying a risk-based approach to our reviews of prospectus and investment fund applications, including enhanced scrutiny for higher-risk applications taking into account our own risk assessment, the European Securities and Markets Authority ("ESMA") risk publications and our ongoing engagements internationally. In addition, [CP142 Consultation on Prospectus Fees and Service Standards \(CP142\)](#) was published on 23 April 2021, and on 15 December 2021, we published a [feedback statement](#) setting out our revised proposals on prospectus fees and service standards.

Our mandate to ensure market **transparency** with particular regard to the features of products (risk profile, appropriateness for retail investors and cost) was a key focus throughout 2021. The Central Bank participated in the Common Supervisory Action ("CSA") on the Supervision of Costs and Fees of Undertakings for Collective Investment in Transferable Securities ("UCITS") that commenced in 2021, necessitating strong supervisory engagement with fund managers.

We continue to stress the importance of **well governed** firms and the Central Bank believes that firms should be guided in all their activities by a commitment to a culture of high standards for investor protection and market integrity. In pursuit of this objective, the closure of actions related to the 2020 [thematic review](#) of Fund Management Companies' Governance, Management and Effectiveness ("FMC Guidance Review") was a key priority during 2021. Specifically, action plans of Fund Management Companies ("FMCs") were reviewed, with a particular focus on day to day operational, resourcing and governance arrangements. In addition, we engaged with FMCs to outline the findings and follow-up actions arising from our review on UCITS Liquidity Risk Management as part of a [CSA](#) coordinated by ESMA.

It is imperative that securities markets are open, transparent and **trusted**, both by those looking to raise capital and those seeking to invest. On 12 July 2021, the Central Bank **published** findings and corresponding expectations after completing its industry-wide review of compliance with the Market Abuse Regulations (“**MAR**”). Following on from this the Central Bank imposed specific risk mitigation programmes on market participants where concerns were identified and we wrote to relevant market participants requiring them to critically assess their MAR operations against the published findings.

The principle that markets are **resilient** enough to operate in stressed conditions has never been more important in the context of the ongoing impacts of Covid-19 and Brexit on securities markets. Covid-19 and Brexit remained a key focus in the context of securities markets supervision, particularly in the funds area. Supervision of the funds sector placed a focus on Money Market Funds (“**MMFs**”), Property Funds and Corporate Bond Funds, as these sectors were identified as being particularly sensitive to recent external market events on matters such as liquidity and asset valuations. We continued to engage extensively with Fund Service Providers (“**FSPs**”) regarding their operational and financial resilience, particularly given the sustained necessity to work-from-home and the continued uncertainty arising as a result of the pandemic.

Data quality and the use of technology continued to be a focus for the Central Bank, enabling us to further develop a supervisory approach that is data driven. There were two data quality reviews for the Securities Financing Transaction Regulation (“**SFTR**”) during 2021 and one for the European Market Infrastructure Regulation (“**EMIR**”). The aforementioned CSA on UCITS Costs and Fees involved extensive use of data analytics, including building survey templates, receiving data through our Online Reporting System and providing quantitative information to the relevant supervisory team to perform analysis. We also continued to build our machine-reading capabilities of text data which reduced time spent manually transposing information and allowed supervisors to use their time more efficiently. Over the course of 2021, we undertook a number of Information Technology (“**IT**”) projects, such as the transmission of data and documentation to ESMA in relation to Prospectus Regulation and Alternative Investment Funds (“**AIFs**”) and UCITS that are marketed in Europe.

Throughout 2021, the Central Bank actively participated in international regulatory fora in securities markets regulation, including potential reform

Despite the ongoing challenges posed by Covid-19, a substantial work programme was completed in 2021

of the MMF framework and the European Commission’s Alternative Investment Fund Managers Directive (“**AIFMD**”) Review consultation. In addition, we engaged extensively with our colleagues at ESMA and the International Organisation of Securities Commissions (“**IOSCO**”) on market conduct issues.

Despite the ongoing challenges posed by Covid-19, a substantial work programme was completed in 2021 and the above summary only highlights a few areas of focus for our people. We will continue this work into 2022 along with a focus on the risks identified in this report.

Misconduct Risk in Securities Markets

As the nature, scale and complexity of securities markets activities taking place in Ireland continues to grow, so too does the risk of misconduct arising in those activities. Our conduct mandate covers a wide variety of market participants that are assessed on an ongoing basis in relation to legal requirements and expectations for good market conduct.



Market Abuse

Market abuse is unlawful behaviour on financial markets that disadvantages investors. Our five principles for proper and orderly securities markets includes the principles of transparency and trust. Behaviours that undermine these principles, such as abusive market practices, damages market integrity, investor protection and confidence in securities markets. Firms and individuals have extensive obligations under Irish market abuse law, including MAR to refrain from, detect, prevent and report these abusive practices. Over the past number of years, the Central Bank has prioritised addressing market abuse issues, most recently through our industry wide thematic review of compliance with MAR, which identified areas requiring significant improvement.

The Suspicious Transaction and Order Report (“**STOR**”) regime is essential to ensuring market integrity and investor protection. In the context of increased trading volumes (including electronic trading) and growing levels of complexity, ensuring STOR levels keep pace and reflect market

dynamics is essential. There have been instances where the Central Bank has received several STORs from market participants on a particular issue but where the market operator or venue fails to generate a STOR on the same issue. This is concerning, particularly given the additional obligations placed on trading venues under MAR and their critical role in ensuring fair and transparent markets. Market operators and investment firms that operate a trading venue are reminded of their obligations to prevent as well as detect and report market abuse.

We continue to see risks arising from deficiencies in firms' trade surveillance systems, which are essential in the detection of market abuse. Surveillance systems that are not effective in detecting abusive behaviours can result in lower levels of trust in securities markets and harm to investors. Shortcomings in setting the parameters of trade surveillance systems reduce the effectiveness of such systems in detecting market abuse with knock on effects on STOR submissions and consequently market integrity and investor protection.

Risks also exist in relation to the establishment and maintenance of insider lists as described under MAR. Insider lists are an invaluable tool for National Competent Authorities ("NCAs") in their market abuse investigations and help maintain and protect market integrity. During the course of our industry thematic review, the Central Bank identified a number of shortcomings regarding compliance with these obligations. These deficiencies are indicative of an ineffective market abuse control environment.

Management Information ("MI") reporting is an important tool to keep Boards apprised of developments in their organisations. An absence of formal, regular and effective MI provided to senior management and Boards regarding trade surveillance was evidenced during the recent MAR thematic review. A lack of informative MI hinders Boards and senior management's ability to assess, challenge and manage market abuse risk.

Trading Outside Mandates

Trading outside of mandates is an operational risk that may manifest in a number of ways including breaching trading limits and traders dealing in financial instruments that are not within their mandates. This risk increases as the scale and sophistication of securities markets activity grows in the jurisdiction. Firms must constantly manage the risks arising from trading outside of agreed mandates and it is essential that firms have

sufficient internal control systems to do so. These controls should include comprehensive systems which can detect breaches in a timely fashion and robust governance processes to deal with those breaches.

We expect financial service providers and issuers of financial instruments to

- Review their compliance with MAR regarding their obligations to submit STORs to the Central Bank where they have a reasonable suspicion that an order or transaction may constitute market abuse
- Ensure trade surveillance systems are configured appropriately to include the full suite of products the firm offers and activities it undertakes
- Review their alert thresholds and parameters on a regular basis and ensure that they evolve with market conditions
- In the case of issuers, understand the full extent of their obligations regarding insider lists under MAR
- Review their internal controls and systems relating to the oversight of trading and adherence to trader mandates

Sustainable Finance

Climate change and the need for coordinated global action to limit its impact on society has brought the topic of sustainable finance into sharp focus. Capital markets, through lending and investment flows, have a central role to play in the transition toward a carbon neutral economy. The Central Bank will continue to play its part in addressing climate risks and the transition to a carbon neutral economy as a strategic priority.



Sustainable finance can be described as the process of placing environmental, social and governance (“**ESG**”) considerations and objectives at the centre of the investment process. As societal attitudes towards climate change have evolved, so too has the demand for financial products that include environmental considerations as part of their investment process. Similarly, social and governance issues, ranging from human rights to board diversity are also key aspects of sustainable finance principles that investors are now seeking. This strong investor demand has resulted in an increased supply of financial products that seek to address this investor appetite. The first half of 2021 saw assets under management for ESG funds and outstanding sustainable debt instruments in Europe continue to increase.

Greenwashing

The growth of the sustainable finance market has increased the risk that some financial products are not as sustainable as claimed. We see risks where investor demand is addressed by products that are marketed with sustainable credentials but in reality do not meet such criteria, a practice known as ‘greenwashing’. If, through inadequate or incorrect disclosures investors are misled into buying products that do not meet their sustainable expectations, it will damage the sustainable finance industry that is crucial to the transition toward greener economic activities. As sustainable finance becomes part of the mainstream investment process, firms need to be cognisant of their responsibilities in this space to ensure investor interests and market integrity are protected.

SFDR Implementation

In response to climate change, a new regulatory framework for sustainable finance is taking shape, following the publication of the European Commission's Action Plan on Sustainable Finance in 2018 and more recently, the Renewed Strategy for Sustainable Economy in 2021. As part of this wider framework, the European Commission has introduced regulation to address the risks arising from greenwashing.

Specifically, the Sustainable Finance Disclosure Regulation (“**SFDR**”) aims to harmonise the rules across the European Union (“**EU**”) on how financial market participants describe sustainability factors and risks in their investment process and for the provision of sustainability related information for financial products. Ensuring investors are fully informed of a financial product's sustainability characteristics in a manner that is measurable and quantifiable, using transparent parameters, is important in building trust in investments to fund the transition to a carbon neutral economy. SFDR Level 1 requirements that applied from March 2021 will be supplemented with Level 2 obligations, applying from January 2023 that are more detailed. Firms will need to devote sufficient resource and management focus to ensure the continued successful implementation of these obligations. Doing so will be important in preventing market fragmentation and promoting confidence in sustainable offerings amongst investors.

In response to climate change, in 2021 the Central Bank established a new Climate Change Unit, to drive forward climate-related work, to ensure cohesion and consistency in the approach across business areas, and to work to further embed, over time, climate risk and sustainable finance considerations into the day-to-day work of the Central Bank. In November 2021, the Governor of the Central Bank wrote to regulated financial service providers to highlight our supervisory expectations, in addition to firms' own statutory obligations related to climate and sustainability issues.

We expect financial service providers to

- Have regard to the supervisory expectations set out in the Central Bank's [climate change and sustainability letter](#)

Governance

A key component of our five principles is the expectation that the market be well governed, and comprise firms that are well governed. We expect that firms' Boards not only receive, but also challenge the information they receive to effect good governance and management over the organisation as a whole.



Board Oversight, Governance Structures & Due Diligence

Effective board oversight, governance structures and due diligence are essential to securing better outcomes for investors and to ensure the financial system as a whole operates effectively. The 2021 Securities Markets Risk Outlook Report highlighted the risks arising from failings related to Board oversight of delegates and third party intermediaries. The risks relating to ineffective Board oversight of delegates and third party intermediaries remain a major factor in the regulatory deficiencies we see across our mandate, including funds, FSPs, investment firms and trading venues.

Appropriate due diligence is an essential requirement before a fund, FSP, investment firm or trading venue enters into a contractual relationship with another entity. Due diligence informs the decision to appoint a third party service provider, and also gives the firm an opportunity to identify and mitigate any areas of risk in advance of entering into a contract. We have seen evidence of fund managers/Boards not undertaking sufficient due diligence of delegates.

Due diligence should be designed to uncover issues and not just to satisfy regulatory requirements. All aspects of the proposed relationship should be scrutinised thoroughly, such as (but not limited to) legal agreements, a delegate's regulated status, stated expertise and prior relationships.

In December 2021, the Central Bank published new [Cross-Industry Guidance](#) on Outsourcing, along with a [Feedback Statement](#) on [Consultation Paper 138](#), in order to support and complement existing sectoral legislation, regulations and guidelines on outsourcing. The Guidance seeks to assist financial service providers to develop their outsourcing risk management framework to effectively identify, measure, monitor and manage their outsourcing risks. It should be noted that the

Central Bank does not consider “delegation” and “outsourcing” as different concepts.

A lack of Board oversight and clear, documented governance structures can also impair financial and operational resilience. For example, FSPs provide important infrastructure to the substantial and growing funds sector and weak oversight could compromise the soundness and stability of this sector, and potentially reduce the sector's capacity to effectively service an expanding client base. In addition, a recent targeted conduct risk assessment on Interbank Offered Rate (“**IBOR**”) transition preparedness (Case Study 1) identified some issues surrounding escalation chains. This assessment again highlighted some incidences of governance practices that fell short of our expectations concerning the escalation of relevant key risks.

Case Study 1

In 2021, the Central Bank carried out a targeted conduct risk assessment of selected credit institutions and international investment firms’ IBOR transition readiness from a conduct perspective. This assessment considered the extent to which firm’s had recognised conduct risks around the IBOR transition, the extent to which they had implemented appropriate consequential controls and the extent to which their frameworks were coping with the transition.

While a number of good practices were observed during the assessments and firms’ transition preparedness was considered to be largely on track for the December 2021 transition deadline, some governance issues were also identified in certain firms, including:

- Accountability, roles and responsibilities were not clearly documented regarding conduct matters around the IBOR transition
- Documentation regarding governance structures did not always clearly specify the escalation chains involved, or how existing governance bodies and subject matter experts contributed to such escalation, and
- In some cases, it was not clear what information was cascaded up and down escalation chains

Fund Management Companies Guidance

Closely aligned with the risk of inadequate Board oversight, governance structures and due diligence, are the findings from the Central Bank’s FMC Guidance thematic review. While progress has been made by many firms following our thematic review intervention, it was found that a significant number of firms had not implemented a governance framework to the standard set out by the Fund Management Companies [Guidance](#) of December 2016 (“**FMC Guidance**”). The risk of not having an appropriate

governance framework materialised in a recent enforcement case referenced in Case Study 2 below.

Deficiencies identified in the review included a failure by FMCs to have appropriate resources at their disposal to enable them to carry out their functions properly. Allied to this, skills and experience of staff were found to be lacking.

Designated persons perform a key role in FMCs. The Central Bank requires FMCs to clearly identify named individuals, who are responsible for monitoring and overseeing the managerial function assigned to the individual. The aforementioned FMC Guidance Review found failures in appointing local designated persons with the relevant skills and appropriate seniority for their managerial function. In many cases, the time committed by the designated person to carrying out the tasks required was insufficient.

Case Study 2

On 27 September 2021, the Central Bank reprimanded and fined a Fund Management Company (the “Firm”) €385,000 in respect of four admitted breaches of investment funds regulations, which occurred between 25 May 2017 and 2 March 2018 (the Relevant Period). This included two Governance and Oversight of Delegates breaches.

The Firm is authorised by the Central Bank as a UCITS fund management company and is managed by a board of non-executive directors (the Board). The Firm uses a delegation model - among its delegations, the Firm delegates investment management services to an investment manager (the Investment Manager)

The Firm’s governance, oversight and monitoring of its delegates was deficient. In particular: The Firm was not consistently receiving all delegate reports and other information mandated under its own procedures to oversee its delegates. The Board only learned of an advertent breach of investment restrictions by a fund it managed 8 weeks after it occurred.

The Board confirmed during its quarterly board meetings that it had received certain delegate reports which it had not in fact received.

The Designated Director for monitoring compliance went on sabbatical for a three month period and The Firm had no alternate Designated Director for monitoring compliance in place for half of that period.

The Firm failed to tailor its oversight and monitoring programme appropriately in respect of a fund merger and in particular did not follow up with the Investment Manager as to the progress of the merger at any point between its approval and completion.

Self-Managed Investment Funds converting to Externally Managed Funds

We have observed a significant increase in the number of self-managed investment funds appointing a third party FMC in order to meet the requirements of the FMC Guidance.

If an FMC is appointed without appropriate checks on that entity, and potential risks are not identified, investors will ultimately be at a greater risk of their investment being mismanaged notwithstanding the best intentions of the FMC.

There is also a risk that the FMC may not have the operational capacity to take on additional funds and therefore, it is imperative that operational systems, resourcing levels and skillsets are reviewed to ensure FMCs can comply with their obligations.

The Central Bank requires third party FMCs to critically assess the impact of proposed new business in order to ensure that they are appropriately resourced to service any additional business. This includes the assessment of revised financial and business growth projections, together with the increased resourcing projections to support this growth.

Did you know?

The amount of third party FMCs appointed by self-managed UCITS in 2021 was three times the previous three years combined

Investment Advisors acting as Investment Managers

The majority of funds and FMCs regulated by the Central Bank operate a delegated model whereby portfolio management is delegated to a third party investment manager, often located in a jurisdiction outside Ireland. While the Board of the fund/FMC is ultimately responsible for compliance with applicable legislation, and must maintain an appropriate level of oversight over the investment manager's activities, the investment manager may act with discretion when managing the relevant fund's portfolio of assets.

The investment manager may, in turn, appoint one or more investment advisors to advise on portfolio management. In all circumstances, the Central Bank expects that the role performed by the investment advisor is non-discretionary in nature and an adjunct to the role performed by the investment manager. The concerns of the Central Bank in this regard relate specifically to cases where an investment advisor is appointed to a fund and that investment advisor is acting with more influence and control than is appropriate. Where this emerges there is often a noticeable

imbalance in the relationship between the management company, investment manager and investment advisor; one that is frequently found in failing investment funds. This imbalance is often recognised and reinforced by other service providers whereby interactions, reporting and the resolution of issues is exclusively with the investment advisor rather than with the management company or investment manager. As an unauthorised entity, there is little or no regulatory oversight of the investment advisor or its staff.

We have noted an increased incidence of investment advisors acting in the capacity of de facto investment managers. This practice is not consistent with the information disclosed in the prospectus and exposes investors to an increased risk of loss of investment.

We expect financial service providers to

- Ensure that Boards are accountable for all aspects of governance, including having a clear organisational structure that defines and clarifies responsibilities for operational, control and reporting processes; and crucially identifies who within the firm is responsible for making key decisions
- Adhere to all legislative requirements on outsourcing and have regard to the new Cross-Industry Guidance on Outsourcing
- For funds/FMCs – Consider and address how resources and operational capacity will need to change to take account of any increase in the nature, scale and complexity of funds under management
- For funds/FMCs - Where investment advisors are appointed in respect of a particular fund, ensure detailed rationale is provided for the appointment and the role the entity will fulfil
- For funds/FMCs – Receive and scrutinise at regular intervals the necessary reports from investment managers on portfolio management, including any interaction with investment advisors during the period in question

Conflicts of Interest

The financial services sector is increasingly interconnected with institutions offering clients a variety of services and products and often transacting on behalf of clients with group companies. This increases the risks associated with conflicts of interest.



Clearly defined arrangements to manage conflicts of interest are crucial in mitigating the potential consequences of a conflict occurring. There are a number of legislative provisions across the EU that require financial service providers to take the necessary steps to ensure conflicts of interest are managed appropriately and do not encroach on the best interests of investors or market integrity. This includes requirements to establish, implement and maintain effective conflicts of interest policies and processes. We continue to see risks where firms do not consider conflicts of interest in their day to day business operations. These considerations should ensure firms are not financially benefiting at the expense of their underlying investors, clients or market counterparties and firms do not have a financial incentive to favour one client over another.

Connected Party Transactions

For investment funds, a fundamental conflict of interest arises around transactions between the investment fund and connected parties, including delegates and service providers. Given the potential for investor harm, the Central Bank views this as an area of particular importance and has developed a set of rules around such transactions: The Connected Party Transaction Rules. These rules provide that connected parties have strict obligations around the identification of such transactions and for fairness in the manner by which such transactions are valued, disclosed and executed. In particular, depositaries and designated persons have specific duties around connected party transactions to ensure that the rules and obligations are correctly applied. While the majority of parties fulfil their obligations to high standards, shortcomings have been observed around the rigour with which some depositaries and designated persons perform these duties.

There are also cases where relevant parties are not being informed when such connected transactions have or are to be undertaken. More worryingly, we note that certain entities identify themselves as not being a connected party or purposefully structure themselves so that they can legally claim to be unrelated when undertaking these transactions. This includes entities forming business relationships with investment managers / investment advisors where no legal relationship exists, but where there are side agreements around the purchasing or financing of assets. Not only can the valuation of these assets be questioned, but at times their eligibility for the investment fund is doubtful. Additionally, once purchased, the investment fund may rely solely on the connected party to value the asset and provide liquidity for any future sale.

Payment for Order Flow (“PFOF”)

A prominent example in recent years of a potential conflict of interest in securities markets has been the issue of PFOF. Increased retail trading activity, precipitated, amongst other things, by the proliferation of zero commission trading has again brought PFOF into sharp focus. PFOF is the practice of brokers receiving payment from a third party for sending client order flow to them for execution.

PFOF enables participation in financial markets by retail clients that may otherwise be inaccessible due to high brokerage fees. This can be seen as a positive development. However, this arrangement may create a conflict of interest in a firm receiving PFOF as it can encourage them to direct orders to the highest paying third party rather than considering what is in the best interest of their clients.

Although explicit trading costs to the client are typically reduced, in reality there is a risk that these could be supplanted by implicit or hidden trading costs, including but not limited to inferior execution prices. In addition to investor protection concerns, there are also a number of concerns related to market structures; with order flow potentially being directed away from transparent and lit trading venues and that execution taking place on over-the-counter markets instead.

PFOF arrangements appear incompatible with a number of provisions in the Markets in Financial Instruments Directive (“**MiFID II**”), including obligations for firms to take appropriate steps to identify and prevent or manage conflicts of interest in the course of their activities. In addition,

PFOF arrangements should not undermine a firm's obligation to obtain best execution for its clients on a consistent basis.

ESMA made a [public statement](#) on investor protection concerns related to PFOF in July 2021 and requested that NCAs prioritise PFOF in their supervisory activities.

In November 2021, the European Commission published a set of legislative proposals that will amend certain aspects of MiFID II / Markets in Financial Instruments Regulation (“**MiFIR**”) (“the MiFIR review proposals”). The wording of the MiFIR review proposals have not yet been finalised but currently include consideration of prohibiting payments for forwarding clients orders for execution.

We expect financial service providers to

- Ensure regulatory requirements on identifying, mitigating and managing conflicts of interest are being met
- Consider, if engaging in PFOF, whether and how best execution requirements are being met on a consistent basis for their clients and to assess their compliance with the conflicts of interest provisions in MiFID II
- Have robust processes and procedures to identify any connected or potentially connected transactions and ensure that all relevant parties understand their obligations and duties with respect to such transactions
- Engage rigorously with their fund depositaries and designated persons when such transactions are being contemplated to ensure that all parties fulfil their obligations with respect to the Central Bank's rules and that the interest of investors is being protected at all times

Financial Innovation

Innovation in financial services continues apace and spans various sectors and products. This growing innovation presents both opportunities and risks to securities markets and investors.



Growth of Retail Investing

A traditional view of retail trading is investors trading in small amounts, with the motivation to increase their personal wealth. However, when such trading is repeated in large coordinated group volumes (sometimes driven by social media), it can have a significant impact on the price of a particular stock. In 2021, media and regulatory attention worldwide was drawn to the amount of retail investor activity driving trading volumes, leading in some cases to significant price volatility.

The rise in retail investment activity in securities markets has sometimes been attributed to the effects of societal restrictions brought on by the pandemic, along with a low interest rate environment making savings accounts less attractive. A combination of these social and economic factors coupled with trading applications offering low or zero commission rates, have likely changed market dynamics and importantly the profile of the “typical” investor. Retail investing in and of itself is not a concern, but there is a risk of bad actors potentially taking advantage of social media platforms to manipulate the market. Allied to this, there are potential regulatory issues arising from an increase in recommendations/views disseminated online by unregulated entities. While such commentary may be of high quality and conflicts declared, investor protection and market integrity may be compromised in some circumstances.

Reports in early 2021 suggested that the social media driven increase in retail trading increased volatility in the price of certain stocks and at a significant scale this type of activity could potentially contribute to more broad based volatility in securities markets. This incident also highlights the coming together of finance and technology with the potential to transform market activity.

Financial Scams

The intersection of finance and technology is also relevant when it comes to the increasingly sophisticated financial scams employed by criminals. The pandemic, and the measures enacted to deal with it by governments worldwide, has increased isolation for millions and made them more vulnerable to scams that can arrive by post, online or by phone.

Financial scams through user generated content sites, cloned webpages and fake advertising/emails that target investors have increased. Left untreated, this risk will expose inexperienced investors to financial loss resulting in the eroding of trust in financial markets.

Fraudsters are increasingly using genuine firms' details to add an air of legitimacy to their fraud. The fraudsters copy some or all of the legitimate information of an authorised firm for the purpose of this fraud. For example, we have noted a 47% increase in fund cloning scams year-on-year between 2020 and 2021. Consumers are advised to check our [register](#) to verify a firm's details and to call the firm directly using its advertised phone number.

New Products

A key feature of financial innovation in securities markets is the development of new products for investors. The demand for such products is driven, in part, by the low interest rate environment, leading to a search for yield in alternative products, thus increasing the risk for investors. The complexity and potential threat to investor protection of some of the new product offerings in securities markets has been noted by the Central Bank. We would like to highlight in particular two products, namely Special Purpose Acquisition Companies ("SPACs") and crypto assets.

SPACs that seek to raise capital through a public offer of shares to retail investors and/or seeking admission to trading on a regulated market, bring the issuance under the remit of the Prospectus Regulation. ESMA issued a [Public Statement](#) on 15 July 2021 to address prospectus disclosure and investor protection considerations. As set out in the Public Statement, ESMA considers that SPAC transactions may not be appropriate for all investors due to a number of factors including, but not limited to, complexity, fees charged and uncertainty regarding identification and evaluation of target companies.

Did you know?

Noting the concerns of ESMA and Regulators more generally with respect to the exposure of retail investors, the Central Bank has limited investments in SPACs to a maximum of 10% of the Net Asset Value (NAV) for retail investment funds

Another innovation in securities market is the growth of digital/crypto related assets. The nature and characteristics of these assets vary considerably, however crypto-assets are likely to be highly risky and speculative. As outlined in a [warning](#) from the European Supervisory Authorities in February 2018, consumers must be alert to the high risks of buying and/or holding these instruments, including the possibility of losing all their investment. In addition, crypto-assets come in many forms but the majority of them remain unregulated in the EU. This means that investors buying and/or holding these instruments do not benefit from the guarantees and safeguards associated with regulated financial services.

The Central Bank has seen an increase in queries in relation to whether UCITS or authorised AIFs may be invested, either directly or indirectly, in such assets. The Central Bank's current position on such assets is outlined in both the most recent [UCITS Q&A](#), and most recent [AIFMD Q&A](#) published by the Central Bank. At the moment, while such assets may be suitable for wholesale or professional investors, the Central Bank is highly unlikely to approve a UCITS or a Retail Investor AIF proposing any exposure (either direct or indirect) to crypto-assets, taking into account the specific risks attached to crypto-assets and the possibility that appropriate risk assessment could be difficult for a retail investor without a high degree of expertise.

Influence of Third Parties

Innovation in securities markets does not just relate to new technologies or products, but also refers to the design of products and entities that may be influencing this design. The design of funds, in particular, is increasingly being influenced by index providers. In addition, certain funds are sold through platforms/distributors, which may influence dealing and settlement times that are not appropriate, taking the liquidity profile of the portfolio of assets of the fund into account.

There has been a move away from active stock selection towards passive index-based strategies. As was noted in last year's Securities Markets Risk Outlook report, this has placed a spotlight on the role of index providers. It is essential that fund managers maintain adequate autonomy over product design and oversight on the selection of index provider, including seeking evidence of initial and ongoing due diligence by the investment manager, and understanding the method and nature of index methodologies, including rebalancing. Governance and oversight by fund managers in the

Did you know?

According to Q4 2021 Fund Profile data, 35% of the Assets under Management of Irish domiciled Funds (excluding MMFs) are passively managed

design process should ensure that the fund is designed to meet the needs of investors.

As regards use of platforms/distributors, we identified certain matters of concern during our work on the CSA on UCITS liquidity management. We noted that in order for funds to be sold through platforms/distributors they must meet certain requirements, including requirements around dealing and settlement times. The risk is that funds, in order to get access to the pool of potential investors available through specific platforms/distributors, adapt themselves to the requirements of the platform/distributor rather than what is appropriate for their portfolio of investments and investors.

We expect financial service providers to

- Be proactive in letting customers know how they will and will not communicate, and what type of information they may periodically require, to avoid customers being deceived
- Immediately contact the Central Bank and/or other relevant authorities (such as An Garda Síochána or another Regulator as appropriate) when they become aware of fraudulent activity, either by a customer or by a cloned entity
- Have regard to the features and complexities of the product they are offering to investors including exposure, risk profile and redemption features considerations
- For funds/FMCs – Maintain an adequate level of oversight and due diligence over the selection of index provider for funds they manage, to ensure the best outcome for investors
- For funds/FMCs – Ensure that dealing and settlement times for funds they manage are consistent with the liquidity profile of the portfolio of assets. If the requirements for onboarding with a platform/distributor are not consistent with the characteristics and profile of the relevant investment fund portfolio, then it is not appropriate to distribute through these means

Data

Data is a crucial aspect of the regulatory toolkit of the Central Bank. As the securities markets industry's use and reliance on data continues to grow, so too does the importance of the quality of that data, including its completeness, accuracy, relevance and consistency. It is vital that the data can be relied upon and that it meets the needs for which it is collected.



Use of incomplete or incorrect data by securities markets participants can lead to poor or incorrect decisions; deficiencies in operations and incorrect views of the organisation and its future. Furthermore, submissions of incomplete or incorrect data by financial service providers to the Central Bank can lead to situations where we are unable to identify and/or not fully understand the broader risks facing securities markets and its participants or can create concerns about a firm where there would otherwise be none.

The volume of new legislation and regulation in recent years has also led to an increase in the amount of data required from financial services providers. Regulations such as the MMF Regulations, EMIR, SFDR, SFTR and MiFIR to name but a few, impose substantial disclosure obligations on securities markets participants.

These reporting obligations increase transparency and enable the Central Bank to obtain a complete picture of a firm's operations and fully understand the risks facing firms operating in securities markets. Many of the data sets we receive continue to have significant data quality issues beyond what can be detected using simple validation rules on submission. Complete, accurate, and timely data is imperative for market monitoring processes and activities.

Given its importance, data quality will remain a focus of the Central Bank in 2022 and it is a key priority of our Strategic Plan to transform the way we operate in a rapidly changing world. Firms can expect increased engagement with the Central Bank in respect of data quality issues. This engagement may take the form of supervisory action where it has been identified that firms do not have sufficient frameworks in place in order to meet their reporting obligations and to ensure data is reported in a complete, accurate and timely manner.

Did you know?

Approximately 4 billion records were received by the Central Bank during 2021 across all securities markets related datasets, with the vast majority relating to records received for EMIR, SFTR and MiFIR

We expect financial service providers to

- Determine whether a dataset is of high quality and whether it meets your organisation's and the Central Bank's needs. Consider if the data is accurate, complete and timely
- Take any data quality issues identified seriously and ensure they are addressed in a reasonable timeframe
- Where data submission is outsourced, have an appropriate level of oversight over the data submitted to ensure it is being submitted correctly – it is not acceptable to solely rely on the outsourced entity to ensure data quality
- When using automated technology to submit returns, ensure that the automated system is fit for purpose, and appropriate and regular checks are in place to ensure complete reporting

Cyber Security

Recent high-profile cyberattacks on institutions have highlighted, once again, the damage that can occur if adequate risk mitigation is not in place in an organisation. This threat is no different for securities markets participants, at both an individual firm and market wide level. Indeed, cyberattacks can represent a systemic risk to securities markets.



Operational Resilience

Financial systems have become increasingly interdependent and interconnected. The acceleration of digital transformation and move to home working as a result of the pandemic has substantially increased the risk of cyberattacks, and financial services continue to be one of the most targeted industries. As a result, cyber security has become a threat to financial stability. As outlined in the Central Bank's [Financial Stability Review 2021:II](#), published on 25 November 2021, operational and cyber resilience of the financial sector (including securities markets) remains a key strategic objective of the Central Bank and [Cross Industry Guidance on Operational Resilience](#) was published in December 2021. Financial service providers need to take steps to understand critical business

Cyber security has long been an area of focus for the Central Bank

services and ensure they are more resilient to disruption from operational and cyber risks.

For example, an efficient and well-executed cyberattack against a stock exchange or any post-trading system (such as a settlement system) could have large-scale repercussions that go beyond the harm to the system/institution itself. It could lead to alarm among investors, triggering a crisis of confidence in the safety of securities markets and subsequent market volatility. Pre-trading systems could also be affected by cyber attackers, for example, manipulating trading algorithms used by high frequency trading firms.

Not all cyberattacks will lead to system wide risks (as certain firms may be less systemically important), but targeted attacks on individual financial service providers will have implications for investors nonetheless, whether via potential monetary loss or theft of personal data.

It is essential that all firms operating in securities markets have appropriate operational resilience in place to mitigate against the threat of cyberattacks. Without controls and procedures in place to identify and minimise sources of information security risk, firms run the risk of being subject to a cyberattack. Cyber security has long been an area of focus for the Central Bank, and recent domestic cyberattacks have strengthened our resolve to ensure regulated financial service providers are adequately addressing this issue.

As was set out in the Central Bank’s 2016 [Cross Industry Guidance in respect of Information Technology and Cybersecurity Risks](#), the Central Bank expects that the Boards and senior management of regulated firms to fully recognise their responsibilities in relation to IT, cybersecurity governance and risk management and place these among their top priorities. A cyberattack on a regulated firm, which could have been avoided if deficiencies had been addressed, will be subject to enhanced regulatory scrutiny.

We expect financial service providers to

- Understand the specific IT related risks that the firm faces and to ensure that these are sufficiently mitigated in line with the firm’s risk appetite

Did you know?

The main cyber-attack methods observed by the Central Bank in the past year include ransomware, DDoS (Distributed Denial of Service Attack), phishing and supply chain attacks

- Undertake regular staff training on all aspects of cybersecurity, with regard to international best practice in this area, including, for example, simulated phishing emails
- Have a program of risk analysis and oversight to identify and minimise sources of cybersecurity risk
- Have emergency procedures, backup facilities, and a plan for disaster recovery that allow for the timely recovery and resumption of operations; and
- Have automated systems that are reliable, secure, and have adequate scalable capacity

Case Study 3

The Central Bank's recent [thematic inspection](#) of cybersecurity risk management in asset management firms, completed in early 2020, noted that, whilst some firms made good progress in certain areas, many of the weaknesses identified in the Central Bank's 2016 Cross Industry Guidance were still prevalent three years later. Cybersecurity is a practice that remains underdeveloped in the Asset Management industry. As noted in the Central Bank's letter to industry in March 2020, deficiencies were identified in some of the following areas: cybersecurity culture in an organisation; cybersecurity risk governance and risk management; having a single, complete IT asset inventory; vulnerability management; security event monitoring and security incident management.

Market Dynamics

Volatility in the price of an asset can be exacerbated by low or variable levels of liquidity, while gains and losses can be amplified by the use of leverage to increase risk exposure. For investment funds, such risk is exacerbated if there is inherent illiquidity in a fund's portfolio and/or through the use of leverage.



As outlined in the Central Bank's Financial Stability Review 2021:II, while global financial conditions have remained accommodative, a sudden tightening in these conditions increases the risks of negative feedback loops arising between asset valuations and redemption activity within certain investment funds.

Fund Liquidity

The low interest rate environment has made investment in higher yielding fixed income instruments more attractive for investment funds. These securities can be less liquid and of lower credit quality, making them potentially more difficult to manage during periods of increased market volatility. This risk has been at the heart of an increased number of supervisory engagements with the funds sector in Ireland including the recent CSA on Liquidity Risk Management.

The Central Bank has reminded FMCs of their responsibilities in this regard in published letters and supervisory engagements over the last number of years. The Central Bank has also strongly influenced related output from ESMA and the European Systemic Risk Board (“**ESRB**”) on this topic which have highlighted a number of adverse supervisory findings. This reinforces the importance of market participants critically reviewing their liquidity risk management frameworks to ensure that all supervisory findings are addressed.

Fund Leverage

Investment Funds can achieve leverage in numerous ways, including through the use of financial derivative instruments and securities financing transactions. The use of leverage can amplify shocks to institutions and markets. Moreover, due to the sometimes opaque nature of derivatives contracts, channels for transmission of these shocks can be less than clear.

The collapse of a US-based hedge fund in March 2021 was an example of leveraged investing having wide ranging impacts. The losses were attributed to the hedge fund’s use of Total Return Swaps (“**TRS**”) and Contracts for Difference (“**CFDs**”), which led to significant losses for the investment banks that facilitated the build-up of leverage by this fund. For these banks, losses have been estimated at US\$6 billion to US\$10 billion from the fire sale, forcing at least one bank to exit the prime broker market.

The above issue highlights the risk of leveraged exposure for a fund and its investors, and to the wider financial system. The use of instruments such as CFDs and TRS may pose a risk to market stability in the event that funds are forced to unwind large positions, as the above incident demonstrated. Furthermore, the [ECB Financial Stability Review](#) from May 2020 examined euro area funds ability to meet variation margin calls and found that a substantial share of euro area funds with derivative exposures faced a

Did you know?

According to the ECB 2020 Financial Stability Review, at the end of March 2020, the notional value of euro area funds’ derivative exposures stood at almost €13 trillion, 18% of which was concentrated in Irish funds

liquidity squeeze from high margin calls during the market turmoil in early 2020.

We expect funds/FMCS to

- Have an appropriate risk management framework in place to identify, manage and mitigate the potential risks arising from use of leverage and liquidity risk within a fund’s portfolio
- Regularly stress test their liquidity and leverage positions against plausible shock scenarios and assess its impact on the fund’s performance and investors redemption requests
- Have regard to:
 - The ESMA [report](#) of 12 November 2020 on the ESRB recommendation on liquidity risks in funds
 - The Central Bank’s [letter](#) to FMCs of 10 March 2021 in relation to the ESMA report of 12 November 2020 on the ESRB recommendation on liquidity risks in funds
 - The matters raised in the ESMA [public statement](#) of 24 March 2021
 - The findings of the Central Bank’s [letter](#) to UCITS FMCs on 18 May 2021

Securities Markets Conduct Supervision Priorities 2022

In determining our supervisory priorities for the coming year, we had regard for our conduct risk identification process, learnings taken from previous supervisory assessments, our work with peer regulators and ESMA colleagues as well as the Central Bank’s new Strategic Plan.

Our supervisory priorities in 2022 aim to further our five principles for a proper and effectively supervised securities market by implementing a number of targeted actions designed to address the key conduct risks we see.



In addition to our ongoing trigger based supervision, a number of supervisory assessments planned for 2022 will be a central component of our priorities. This will include completing the Common Supervisory Action (CSA) on Valuations in the funds sector and following up on our FMC Guidance Review and the CSA on UCITS Costs and Fees. We will continue to engage strongly with depositaries and fund administrators, including conducting targeted risk assessments focussing particularly on governance, operational and capital risk. We will also be undertaking a number of full conduct risk assessments on firms in our jurisdiction while continuing to develop and enhance our supervisory approach to market abuse risks.

This year will also see a defined plan of work with Enforcement, to include both specific cases across our mandate and assessment and investigation of suspected market abuse. Ongoing collaboration with An Garda Síochána and other regulatory authorities remains a key focus of the work undertaken in the Directorate. In addition, we will continue the planned Supervisory Review Framework project for SMSD's mandates, focusing on the review of the PRISM impact rating model for funds and related supervisory engagement. We will also complete further revisions to our Gatekeeper Approach and apply our ROBUST principles to evaluate authorisation proposals and business expansion applications from a conduct risk perspective.

Building on the work already undertaken, and as part of the multi-year data strategy, we will continue to develop our data capabilities including new tools and enhanced infrastructure to improve data quality and better inform our approach to and understanding of risk assessments.

Our 2022 priorities will also be reflected in our international regulatory engagements, with a particular focus on supervisory convergence and the development of our approach to data with our colleagues at EMSA. We will continue to work closely with ESMA and other European colleagues to develop a more pan-EU approach to wholesale market conduct issues and supervision, a key part of this being the ESMA Heatmap exercise, which promotes a common EU risk-based and outcome-focused supervisory convergence culture.

We will also continue to foster international cooperation around conduct supervision with IOSCO members under the Multilateral Memorandum of Understanding. The Central Bank is an active participant at IOSCO in driving strategic priorities and is a member of the IOSCO Board. The

Central Bank serves as vice chair of IOSCO's European Regional Committee and co-chair (with the Australian Securities and Investments Commission) of the Board level task Force on Retail Market Conduct which, in light of COVID-19 focuses on examining potential retail misconduct risks arising in the financial services industry. The Central Bank is also represented on the Board-Level Financial Stability Engagement Group, which has provided advice on issues such as MMF reform, corporate bond market liquidity and margining practices.

The contents of this report are not an exhaustive list of risks in securities markets or the Central Bank's regulatory focus, rather it should be viewed as another tool for securities markets participants to help aid, develop and embed appropriate compliance processes. In addition, firms are exposed to unforeseen external shocks that can significantly affect their operations in unexpected ways. Therefore, it is prudent for firms to stress test their operations, such as business continuity plans and escalation mechanisms on feasible worst case scenarios to ensure they maintain their regulatory responsibilities.

The Central Bank encourages all securities markets participants to review the risks and supervisory priorities outlined in this report and to consider incorporating practices relevant to their business activities into their own risk assessment and mitigation programmes.

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