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INVESTMENT FUNDS ALERT

FSA ANNOUNCES PROGRAMME OF VISITS TO HEDGE FUND MANAGERS TO MONITOR MARKET ABUSE SYSTEMS AND CONTROLS

Following a series of visits to hedge fund managers (HFMs) the United Kingdom Financial Services Authority (FSA), in its recent Market Watch newsletter (http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter24.pdf), has announced a programme of visits to a wide cross-section of HFMs over the coming months to formally assess market abuse systems and controls.

The FSA acknowledged that HFMs range from very small concerns to global organisations, and have set out their recommended compliance measures accordingly. During recent exploratory visits to HFMs, the FSA found, in some cases, a high level of awareness and appropriate controls, whilst in others, fewer controls and "a complacent attitude to the risks." Whilst the measures summarised below are not formal FSA guidance, we feel that it would be good practice for a HFM to ensure that appropriate systems are in place ahead of any possible visit.

The FSA has consolidated its findings into a series of minimum requirements, alongside recommendations for the kind of measures that a HFM ought to consider when operating a market abuse compliance system, both of which we set out below.

- ***Responsibility for compliance*** – a HFM must recognise that the responsibility for compliance with the market abuse regime lies ultimately with senior management, and not the compliance team. However, all staff within a HFM have a role in combating market abuse, and must be aware of the part that they can play.

- ***Independent monitoring*** – a HFM must, whatever its size, have in place some independent monitoring of their market abuse controls and procedures. This monitoring can be in-house or through the use of an external resource, but must be appropriate to the individual firm. "Box-ticking" exercises **do not** meet the appropriate standard. Each firm should assess the market abuse risks that it is exposed to and monitor the controls in place to manage those risks.

- ***Training*** – staff operating within a HFM must receive appropriate and regular training, tailored to the HFM's business, and containing practical examples relevant to the business. This is the responsibility of senior management, who cannot rely on training given by previous employers.

- ***Restricted/stop lists*** – a HFM must maintain a restricted/stop list of all securities (not just equities) on which it has received inside information, and where, in consequence, trading is restricted.

- ***Dissemination of information/rumours*** – a HFM must have in place policies to ensure that staff are aware of the need to maintain confidentiality of information received concerning price sensitive events.

In addition or in relation to the above, the FSA recommended that HFMs should consider the following measures when putting into place or assessing their compliance regime to assist in the prevention of market abuse:

- ***Systems and controls*** – putting into place controls such as restricted access to system drives and prompts which indicate if a trade is about to be executed in a security included on a restricted list
- ***Monitoring*** – reviewing the reasons for trading securities that are being traded for the first time or that are traded before an unscheduled regulatory announcement
- ***Chinese Walls*** – where Chinese Walls are used in preference to operating a firm-wide restricted/stop list, a HFM should be able to demonstrate that it has robust procedures to ensure that their Chinese Walls operate effectively
- ***Remuneration structures*** – putting into place a long term remuneration structure, based upon either individual or firm-wide performance. This may, to a limited extent, reduce the incentive for staff to undertake market abuse for short term gain
- ***Taped telephone lines*** – recording telephone conversations, particularly where staff operate relatively independently
- ***PA dealing*** – annually reviewing the PA dealing of all staff retrospectively
- ***Inside information*** – where there is a risk that a company may inadvertently provide inside information during a one-to-one meeting with a HFM, it may be beneficial for the HFM to make clear before such a meeting that they do not wish to receive inside information. Additionally, you may wish to consider, if appropriate, having a member of the compliance team accompany investment managers to any such meeting. In any event, a HFM should be able to show that it has procedures to manage this risk, and that if any inside information is received, it is not traded on.

The above recommendations are not exhaustive, being as they are a summary of the FSA's findings. They do, however, provide a starting point that we recommend you consider ahead of any possible visit from the FSA.

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