FSA Issues Additional Observations on the State of Market Abuse Controls Among Hedge Fund Managers

In October 2007, in its publication *Market Watch 24*, the Financial Services Authority ("FSA") set out its findings on the extent and appropriateness of market abuse controls among a cross-section of hedge fund managers. Expressing itself "disappointed by some of what we saw," the FSA committed itself to not merely follow up with the firms visited, but also to undertake further visits to a wider cross-section of hedge fund managers. A year later, the FSA has published the results of this additional initiative in *Market Watch 29*.

Although *Market Watch 24* does not make this point directly, it looks as if the results of its earlier survey had led the FSA to conclude that there might be a problem with the controls that hedge fund managers generally had in place to deal with market abuse, and as a result a wider survey was necessary to establish whether that was the position. However, if that were the rationale for the FSA's further initiative, the results conveyed in *Market Watch 29* indicate that there is not a general problem among hedge fund managers in this area. As the FSA notes, "all firms appeared to have given reasonable consideration to market abuse issues," and all firms monitored trading activity and operated a personal account dealing policy. So the impression that *Market Watch 24* perhaps unwittingly gave — that this was a sector of the market where controls were particularly lax — has not been supported by the FSA's further work.

Nonetheless, there were a number of areas where the FSA identified aspects to which firms should pay particular attention and where improvements to existing procedures could be made:

- **compliance**: firms should ensure that, as far as possible, the compliance and executive functions should be kept separate (for instance, through the use of external compliance consultants);

- **control of inside information**: firms should limit the distribution of restricted lists to those individuals who need to know, and should have a process in place to determine what information is made available under non-disclosure agreements, so as to be better able to proactively monitor subsequent trading;

- **monitoring of trading activity**: firms should not rely simply on the fact that they operate in an open-plan environment, and/or have remuneration structures in place that are long-term in nature, as reasons for thinking that they have taken sufficient measures against the risks of market abuse. Instead, they should monitor trading activity generally, particularly around valuation dates and company announcements. The FSA suggests that, as many hedge fund managers are not large enough to justify the installation of sophisticated computer detection systems, they should maintain "reason for trading" records;

- **training:** it is not enough to rely simply on online training in relation to market abuse issues; there should be face-to-face training using case studies relevant to the firm's business;

- **personal account dealing**: firms should consider receiving copy contract notes to record and verify employee dealings; and

- **telephone taping**: firms should consider the need to introduce a mobile phone policy (this seems strange, as the relevant FSA rules coming into force in March 2009 expressly exclude mobile phones from their scope).

The FSA concludes its remarks by making the unexceptional point that market abuse controls should not be regarded as something that firms can ”fit and forget”; they should regularly consider whether their existing procedures remain suitable to their businesses. But it is odd that the FSA should raise the short selling restriction introduced in September in this context and seemingly criticize firms for not anticipating such a change. Firms could surely be forgiven for failing to do so, particularly given that, less than 24 hours beforehand, the FSA chief executive was publicly stating that short selling had a legitimate role to play in the markets.

Although hedge fund managers have received a relatively clean bill of health from the FSA as regards their market abuse controls, *Market Watch 29* is no reason for complacency. Given the importance to the FSA of curbing market abuse, and the consequent risk of the FSA taking action against any firm it thinks has fallen short of the appropriate standards, firms should regularly review the effectiveness of their market abuse controls and make any necessary changes.

Firms that have signed up, or are considering signing up, to the standards overseen by the Hedge Fund Standards Board should note that these standards contain provisions regarding effective arrangements for the identification, detection and prevention of market abuse, as well as a requirement for hedge fund managers to disclose to investors that they have a policy to prevent market abuse (Standards 23 and 24). This is a clear sign that the industry, as well as the regulator, takes this matter seriously, and that firms will be falling short of industry best practice if they do not follow suit.

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