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It all came out in the wash: FS market lessons for intermediaries

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15 January 2020

Lessons from one FS market for intermediaries in all: superfluous involvement; superficial oversight

The Financial Conduct Authority's £15.4 million fine in October 2019 against Tullett Prebon ("TP") has ramifications for all financial services intermediation and distribution, not just the securities trading market.

First, the Final Notice makes explicit that non-value adding intermediation constitutes grounds for regulatory intervention. The sanction against TP is levied at a time of scrutiny of the role and conduct of financial services intermediaries, including in securities trading and the general insurance distribution chain. The Final Notice adds to the substantial list of types of misconduct that all intermediaries should understand and seek to prevent.

Second, the regulator's approach to the misconduct in issue provides a useful insight into the difficulties that, before the Senior Managers & Certification Regime ("SMCR"), seemed to exist in identifying and punishing a 'lack of integrity' on the part of firms and individuals. The nature and extent of these difficulties, and the new potential for the FCA to overcome them, are worth considering for firms and their senior managers.

Non-value adding intermediation

The backdrop: the decline of interdealer broking

The events giving rise to the fine occurred in 2008-13 when financial markets were suffering from persistently low liquidity following the global financial crisis.

During those years traders increasingly traded through electronic platforms rather than through interdealer brokers - such as TP - who matched buyers with sellers by calling around their network off-exchange, or 'Over The Counter'. Industry observers at the time and since noted that the rise in platform trading led to a decline in such 'relationship-based' broking. The merger of TP and ICAP in 2016 was seen by some as the natural consequence of these market changes.

The two key trade mechanisms used to generate 'unwarranted brokerage'

During this time, brokers from across four desks of the firm's Rates division, *"acted with traders to put in place improper trades for the purpose of generating unwarranted brokerage payments".*

The majority of unwarranted brokerage was made through wash trades: equal and opposite trades between two parties that cancel out. The FCA has described these as *"a sham"*, that have as their *"sole purpose the generation of brokerage."*

The regulator also noted a second mechanism: three-party switches. Here, a third party is interposed in the middle of a legitimate trade between two firms. It is of course possible that such interposition could have a legitimate commercial function, such as to mitigate credit risk as between the original trade parties. However, the regulator noted that if the third party was merely *"assisting the other parties to facilitate their trade with no benefit"*, then any brokerage payable to or for such third party's involvement would be unwarranted.

Root cause analysis: corporate / personal gain at the expense of market functionality

The FCA states that TP brokers were motivated *"to improve the profitability of their books (which would ultimately feed into their own personal remuneration through bonus payments)"*, and the traders paying brokerage were motivated by *"the receipt of entertainment and promises of assistance in the attempted manipulation of LIBOR"* provided by TP brokers. The regulator noted that brokerage was also sometimes paid *"as a 'tip' from the trader to the broker."*

On one occasion, a trader also agreed to pay a higher price on a trade, one which would *"clear a trading loss of £150,000 that [TP's] overseas office was potentially going to incur,"* in return for the payment of expenses on *"a 10-day trip to Las Vegas and California."* This trip incurred *"over US$30,000 in expenses"* and involved *"expensive bars and restaurants and the hire of two high performance sports cars."*

The FCA concluded that the payment of unwarranted brokerage created a *"risk of loss to other market users"* such as competitor brokers, investment banks, and their respective clients. The FCA also considered the risk of harm to trust and confidence in the market, noting that the behaviour undermined *"the proper function of the market"*. The findings in the Final Notice were, in effect, that brokers and traders exploited the ignorance of their clients as to the mechanics of trades.

As discussed below, the Final Notice relates to TP's breaches of FCA Principles #2 ('due skill, care and diligence'), #3 ('effective systems and controls') and #11 ('open and cooperative dealing with the FCA'). However, similar events in other markets could sound in additional principles breaches, in particular #5 ('market conduct'), #6 ('treating customers fairly'), #7 ('clear, fair and not misleading communications with clients') and #8 ('conflicts of interest'). There could also be questions as to Principle 1 ('integrity') and legal issues as to 'breach of fiduciary duty' / 'secret profits'.

Breaches of principles 2, 3 and 11

As one would expect, the FCA found a breach of Principle 3 by reason (in short) of ineffective trade monitoring and systems for TP's compliance unit function to carry out its function. A particular breach arose of Principle 2 *"when [managers] were faced with blatant signals of broker misconduct [and] took no action."*

Principle 11 was breached in three ways:

- by a manager, wrongly and without checking, telling the FCA that call recordings potentially evidencing non-compliant TP trades had not been retained;
- by TP's failure to update the FCA that the recordings had subsequently been located; and
- an incorrect explanation as to how the recordings were found.

Just under a third of TP's fine was specifically due to Principle 11 failings.

Recklessness, but no lack of integrity?

Intriguingly, the Final Notice gives examples of recklessness on the part of TP, but these examples appear to have been insufficient to trigger a breach of Principle 1:

- senior managers *"that were aware of large brokerage payments and then told 'you don't want to know' were reckless as they must have appreciated the possibility of a risk, but took no action";*
- a senior manager failed *"to take any action once he had learned that entertainment expenses were being used to improve the price of a trade"*; and
- TP's explanation of how relevant recordings had been found was based on an unverified assumption.

Practitioners may speculate as to how it was that reckless decisions not to act, or recklessly made statements, do not amount to a lack of integrity. Compare the findings against TP with cases where Principle 1 was breached, such as:

- Catalyst Investments from 2013 (*"a reckless disregard for the interests of investors"* in promoting and taking payments for the purchase of bonds from a company that was not permitted to offer them); and
- Coverall Worldwide from 2016 (*"recklessly failing to mitigate the risks to potential policyholders arising from the contracts entered into by its appointed representative"* in relation to sub-delegation of authority given without permission from the relevant principal).

Nevertheless, while the recklessness of senior managers at TP did not result in a finding of a breach of Principle 1, such recklessness was taken into account in the calculation of the fine against TP.

Notably, TP's managers' recklessness occurred before SMCR's emphasis on personal accountability. Even though there appear to be no sanctions for individual managers at TP, it would be imprudent, now that SMCR is in place, for senior managers to assume that any personal recklessness on their part would not result in severe sanctions against them individually.

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