[2019] UKUT 0115 (TCC)

Case number FS/2018/054

Financial Services and Markets Act 2000 – lack of monitoring system to prevent or detect market abuse – penalty

IN THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

FINANCIAL SERVICES

IN THE MATTER OF THE FINANCIAL SERVICES AND MARKETS ACT 2000

BETWEEN

LINEAR INVESTMENTS LIMITED

Applicant

-and-

THE FINANCIAL CONDUCT AUTHORITY

Respondent

Tribunal: **Andrew Bartlett QC (Judge of the Upper Tribunal)**

Martin Fraenkel (Tribunal Member)

John Woodman (Tribunal Member)

Date of hearing: 6 March 2019

Date of written decision: 9 April 2019

Counsel for the applicant: Oliver Assersohn

Counsel for the Authority: Simon Pritchard

DECISION

CONTENTS **Paragraph**

DETERMINATION

For the reasons set out below, the Tribunal confirms on this reference that the appropriate action for the Authority to take is to impose a penalty of £409,300 on the Applicant.

INTRODUCTION

1. This is a reference to the Tribunal pursuant to s 208 of the Financial Services and Markets Act 2000 ('FSMA' or 'the Act').

2. On this reference the Applicant, Linear Investments Limited, appeals against the amount of a penalty decided upon by the Financial Conduct Authority ("FCA" or "the Authority") for breach of Principle 3 of the Principles for Businesses. The breach comprised a failure to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems in relation to the detection and reporting of potential instances of market abuse between 14 January 2013 and 9 August 2015 ("the Relevant Period"). The penalty is the sum of £409,300.

3. This is the first reference to the Tribunal in a case where the parties made a Focused Resolution Agreement ("FRA"). The FRA was made on 27 November 2017. This was a contract by which they agreed not to dispute, on a reference to the Tribunal, the matters of fact and liability in sections 2 to 5 of the Authority's Draft Warning Notice. However, if the Tribunal declines of its own motion to accept the parties' agreed position in some respect, the parties are then free to adduce evidence or make representations about that particular matter.

4. DEPP 6.7.3A of the Authority's penalty policy explains that where the Authority has entered into a focused resolution agreement it will apply a 30% reduction to the penalty that would otherwise be imposed if, as here, the agreement is concluded during "Stage 1" (the stage in enforcement proceedings when the Authority has a sufficient understanding of the nature and gravity of the breach to make a reasonable assessment of the appropriate penalty, has communicated that assessment to the firm and has given it a reasonable opportunity to reach agreement as to the amount of the penalty). A 30% reduction has therefore been applied in the present case. In the absence of the settlement discount, the penalty would have been £584,700.

THE MATTERS AGREED IN THE FRA

5. Although the matters agreed in the FRA include some repetition, it is convenient to set out in full the wording agreed by paragraph 1 of the FRA. It is as follows:

SUMMARY OF REASONS

2.1 The Authority proposes to take this action because Linear breached Principle 3 of the Principles for Businesses by failing to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems in relation to the detection and reporting of potential instances of market abuse between 14 January 2013 and 9 August 2015 (the "Relevant Period").

2.2 Market abuse in any form is serious and undermines confidence in the integrity of the UK financial services sector, and as such detecting it is a high priority of the Authority. Firms must establish appropriate systems and controls to identify and manage the particular market abuse risks to which they are exposed.

2.3 A cornerstone of the regime in place to protect markets from abuse is the requirement on firms to identify where there are reasonable grounds to suspect market abuse has occurred and to submit Suspicious Transaction Reports ("STRs") or, after 3 July 2016, Suspicious Transaction and Order Reports ("STORs") to the Authority. These are a critical source of intelligence for the Authority in identifying possible market abuse.

2.4 To conduct effective monitoring for suspected market abuse firms need to have trade monitoring systems which are appropriate relative to the nature, scale and complexity of the business they are undertaking and to the market abuse risks to which that business is exposed. Firms should have adequate systems in place so that they are able to comply with their regulatory obligations at all times, including where the business model changes.

2.5 Linear is an FCA authorised firm offering brokerage services. It provides its customers with a range of services, including trade execution where it places orders on behalf of clients. Linear also acts as a principal for a number of Appointed Representatives ("ARs"), which operate in a number of fields including brokerage, asset management and research. As the principal firm, Linear is responsible for any authorised activity undertaken by the ARs.

2.6 Trading is primarily conducted via electronic Direct Market Access ("DMA"), which Linear routes to its own broker for transmission to the market.

2.7 Linear's business model has changed over time, with it becoming more focussed on providing trade execution services to clients from the first half of 2013 onwards. During the Relevant Period the volume of trades routed by Linear to its brokers was significant, having increased substantially in volume from mid-January 2013 onwards. On average, some tens of thousands of trades were reported per month in the Relevant Period. This number of trades had increased significantly from the levels in 2012. From 14 January 2013 to 11 May 2015 the volume of trading was at a level which meant that it was not capable of being adequately monitored by the manual only process in place at Linear during that time.

2.8 Up until November 2014 Linear operated on the basis that it could rely upon post-trade surveillance undertaken by underlying brokers to discharge its regulatory obligations. This was incorrect. Regardless of post-trade surveillance checks being undertaken by underlying brokers, Linear was also responsible for undertaking its own checks using information available to it. Linear was at all times responsible for ensuring that it had effective post-trade surveillance systems in place to enable it to detect and report potential instances of market abuse. Later in the Relevant Period, as a result of discussions with a broker in November 2014, Linear became aware of the need to conduct its own post-trade surveillance. Only following this did Linear take steps to source and install an automated post-trade surveillance system.

2.9 There was a further period of time after deployment of the system on 11 May 2015 before Linear had appropriately calibrated and tested the system so that it was operating effectively relative to the nature of its business. This included periods of time during which Linear had to disable alerts on the automated system in relation to spoofing and insider dealing, because the system had not been appropriately and correctly calibrated. When the Firm disabled these alerts it did not have suitable *alternative surveillance in place. This rendered it incapable of effectively detecting spooling and insider dealing whilst the alerts were disabled.*

2.10 As a result during the Relevant Period Linear failed to take reasonable care to ensure that it could effectively conduct market abuse surveillance, which increased the risk that potentially suspicious trading would go undetected.

2.11 Tackling market abuse, in whatever form, remains a high priority for the Authority and it views Linear's failings as serious. The Authority therefore proposes to impose a financial penalty on Linear in the amount of £454,700 pursuant to section 206 of the Act.

DEFINITIONS

3.1 The definitions below are used in this Warning Notice.

"the Act" means the Financial Services and Markets Act 2000

"the Authority" means the body corporate previously known as the Financial Services Authority and renamed on 1 April 2013 as the Financial Conduct Authority

"DMA" means direct market access and is an electronic trading facility that enables investors in financial instruments to directly place orders and trade via the order books of major exchanges

"ESMA Guidelines" means the European Securities and Markets Authority Guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities, effective from 1 May 2012

"Principles" means the Authority's Principles for Businesses

"the Relevant Period" means the period from 14 January 2013 to 9 August 2015

"STR" means a Suspicious Transaction Report through which a firm, which arranges or executes a transaction for a client and which has reasonable grounds to suspect that the transaction might constitute market abuse, must notify the FCA

"STOR" means Suspicious Transaction and Order Reports which, from 3 July 2016 onwards, imposed an obligation on firms and trading venues to report suspicious 'orders' in addition to transactions, as well as 'attempted market abuse'

"the Tribunal" means the Upper Tribunal (Tax and Chancery Chamber)

FACTS AND MATTERS

Background to Linear

4.1 Linear is, and was during the Relevant Period, a brokerage firm authorised by the Authority. It provides its customers with a range of services, including placing trades on behalf of clients with wholesale DMA providers. It also acts as a principal for a number of Appointed Representatives ("ARs"), which operate in a number of fields including brokerage, asset management and research. As principal, Linear is responsible for any authorised activity undertaken by the ARs.

4.2 Trading is primarily conducted via DMA, which Linear routes to its own brokers for transmission to the market. Linear does not have its own DMA capability. Linear enters into DMA agreements with the wholesale brokers and separately enters into individual contracts with clients who wish to trade so that Linear operates what it describes as a 'back to back' service. The nature of this DMA trading is that there is little, if any, contact with the Linear front office meaning that compliance-based surveillance is the primary method by which Linear can monitor trading activity.

Market Abuse controls and the STR regime

4.3 During the Relevant Period firms carrying out activities from an establishment in the UK which arrange or execute transactions with or for a client and which have reasonable grounds to suspect that the transaction might constitute market abuse, must notify the Authority without delay i.e. submit an STR. STRs, and now STORs, are a crucial asset in the detection of market abuse and are key to the Authority's ability to protect and enhance the integrity of the UK financial system. The relevant provisions of the Authority's Handbook are set out in the Annex.

The Authority's statements on post-trade surveillance, DMA and STRs.

4.4 In December 2006, Issue 18 of Market Watch referred to the need for firms to have in place appropriate and robust monitoring systems and reminded firms of their obligations under the STR regime.

4.5 In March 2007, Issue 19 of Market Watch contained further emphasis on the importance of STRs and included a number of case studies on STRs. This further highlighted the importance of STRs to address market abuse.

4.6 In August 2009, Issue 33 of Market Watch highlights that firms who offer their clients DMA should ensure that they have appropriate systems and controls in place to identify and prevent market abuse. Reference is made to the relevant provisions of FSMA and to the Code of Market Conduct (MAR) for guidance on the market abuse regime.

4.7 In December 2012, the Authority sent a letter to all authorised firms including Linear. It reminded firms of their obligations to have appropriate systems and controls in place as per ESMA Guidelines which became effective as of 1 May 2012. The letter also reminded DMA providers of their responsibility for the trading of their clients and *the need to monitor the trading activities of clients, which involves having adequate market abuse detection systems in place.*

4.8 In July 2014, Issue 46 of Market Watch provided an overview of price spikes caused by errors in algorithmic trading and notes that "where firms provide Direct Market Access (DMA) or Sponsored Access to other firms or clients, they are responsible for the trading of that client, which is in line with Guideline 8 of the ESMA guidelines."

Linear's market abuse surveillance systems and controls

4.9 Prior to installation of an automated post-trade surveillance system on 11 May 2015, Linear had no post-trade surveillance system in place, and relied on limited manual oversight of transactions executed via its outsourced trading platform. When Linear's business model changed, and the volume of trading increased significantly, it failed to consider whether the risks to which they were exposed had been elevated and whether they needed to install an automated post-trade surveillance system.

4.10 It was only in November 2014 that Linear became aware of the need to conduct its own post-trade surveillance. Linear mistakenly considered prior to that time that the requirement to analyse and report suspicious trades was effectively being carried out on their behalf by underlying brokers. Linear would provide the underlying broker with information if they requested it for further analysis in the event that there were any potential suspicious transactions. Linear was mistaken in its view held prior to November 2014 that the co-operation between themselves and underlying brokers was sufficient to meet their regulatory obligations. Linear failed to realise that, regardless of post-trade surveillance checks being undertaken by underlying brokers, Linear was also responsible for undertaking its own checks using information available to it.

4.11 As soon as Linear became aware of the need to conduct its own post-trade surveillance its initial decision was to build the system in-house, but Linear later took the decision to abort the in-house project and it sourced and deployed an automated post-trade surveillance system. There was a further period of time after installation before the Firm had appropriately calibrated and tested the system so that it was operating effectively relative to the nature of its business. This included periods of time during which Linear had to disable alerts on the automated system in relation to spoofing and insider dealing because the system had not been appropriately and correctly calibrated. When the Firm disabled these alerts it did not have suitable alternative surveillance in place. This rendered it incapable of effectively detecting spoofing and insider dealing whilst the alerts were disabled.

4.12 As a result, Linear failed to take care to ensure that it could conduct post-trade surveillance adequately, which increased the risk that potentially suspicious trading would go undetected.

FAILINGS

5.1 The regulatory provisions relevant to this Warning Notice are referred to in Annex A.

5.2 Principle 3 requires a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

5.3 Linear breached Principle 3 because it failed to organise and control its affairs responsibly and effectively with adequate risk management systems in relation to the identification and reporting of possible market abuse.

5.4 On the basis of the facts and matters set out above, Linear failed to maintain an appropriate control environment in order to detect and report potential instances of market abuse. Linear had mistakenly relied upon underlying brokers to undertake surveillance on their behalf. They had no post-trade surveillance system in place until they introduced an automated post-trade surveillance system in May 2015, only having some limited manual oversight prior to that time.

5.5 Following acquisition of the post-trade surveillance system Linear had to temporarily disable the spoofing and insider dealing alerts because the system had not been appropriately and correctly calibrated. When the Firm disabled these alerts it did not arrange adequate alternative methods to identify the respective market abuse behaviours. It was not until 9 August 2015 that the automated system was effectively tested and calibrated with all alerts being active. This rendered it incapable of effectively detecting insider dealing and spoofing.

*ANNEX 1 [*sic*]*

RELEVANT STATUTORY PROVISIONS, REGULATORY REQUIREMENTS AND FCA GUIDANCE

1. REGULATORY PROVISIONS

1.1. In exercising its power to issue a financial penalty, the Authority must have regard to the relevant provisions in the Handbook of rules and guidance (the "Handbook").

1.2. In deciding on the action proposed, the Authority has also had regard to guidance published in the Authority Handbook and set out in the Regulatory Guides, in particular the Decision Procedure and Penalties Manual ("DEPP") and the Enforcement Guide ("EG").

2. PRINCIPLES FOR BUSINESSES (PRIN)

2.1. The Principles are a general statement of the fundamental obligations of firms under the regulatory system and are set out in the Handbook. They derive their authority from the rule-making powers as set out in the Act and reflect the Authority's regulatory objectives.

2.2. Principle 3 provides: "A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems".

SYSC 6.1.1R, which states that "a firm must establish, implement and maintain adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and appointed representatives (or where applicable, tied agents) with its obligations under the regulatory system."

ESMA Guidelines "Systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities". Guideline 6 provides guidance for investment firms in relation to the prevention of market abuse in an automated trading environment. Under the first 'General guideline' it states that "Investment firms should have policies and procedures in place to minimise the risk that their automated trading activity gives rise to market abuse (in particular market manipulation)'. The 'Detailed guidelines' include under provision c) headed 'Monitoring Activity' 'Investment firms should monitor the activities of individuals/algorithms trading on behalf of the firm and the trading activities of clients, taking account of orders submitted, modified and cancelled as well as transactions executed. This should involve having adequate systems in place (including automated alert systems), using a sufficient level of time granularity, to flag any behaviour likely to give rise to suspicions of market abuse (in particular market manipulation), including (where the firm has sight of this) cross-market behaviour".

Guideline 8 refers to 'Organisational requirements for investment firms that provide direct market access and/or sponsored access'. The 'General guideline' states that "Investment firms offering DMA/SA to clients ('DMA/SA clients') are responsible for the trading of those clients. They must establish policies and procedures to ensure the trading of those clients complies with the rules and procedures of the relevant trading platforms to which the orders of such clients are submitted and enables the investment firm to meet its obligations under MiFID and other relevant Union and national law".

3. SUPERVISION MANUAL (SUP)

3.1. SUP sets out the relationship between the FCA and authorised persons (referred to in the Handbook as firms). As a general rule, SUP contains material that is of continuing relevance after authorisation.

3.2. The relevant rules are as follows:

SUP 15.10.1 R provides: "This section applies in relation to activities carried on from an establishment maintained by the firm or its appointed representative in the United Kingdom".

SUP 15.10.2 R provided from the start of the relevant period up to 5 February 2014: "A firm which arranges or executes a transaction with or for a client in a qualifying investment admitted to trading on a prescribed market and which has reasonable *grounds to suspect that the transaction might constitute market abuse must notify the [FSA][FCA] without delay".*

SUP 15.10.2 R provided from 6 February 2014 onwards: "A firm which arranges or executes a transaction with or for a client and which has reasonable grounds to suspect that the transaction might constitute market abuse must notify the FCA without delay".

SUP 15.10.3R, which states that the firm "must decide on a case-by-case basis whether there are reasonable grounds for suspecting that a transaction involves market abuse, taking into account the elements constituting market abuse."

4. ENFORCEMENT GUIDE (EG)

4.1 The Authority's approach to taking disciplinary action is set out in Chapter 2 of EG. The Authority's approach to financial penalties and public censures is set out in Chapter 7 of EG. EG 7.1 states that the effective and proportionate use of the Authority's powers to enforce the requirements of the Act, the rules and the Statements of Principles for Approved Persons will play an important role in the Authority's pursuit of its regulatory objectives. Imposing financial penalties and public censures shows that the Authority is upholding regulatory standards and helps to maintain market confidence and deter financial crime. An increased public awareness of regulatory standards also contributes to the protection of consumers.

THE PENALTY

6. Although the draft Warning Notice included in the FRA proposed a penalty of £649,713 (to be reduced to £454,700 by the 30% discount), in the Decision Notice the FCA assessed a penalty of £584,700, which by application of the discount was reduced to £409,300.

7. DEPP 6.5A sets out a five-step penalty policy. Step 1 (disgorgement) does not apply, so the process commences in this case with Step 2. The Authority's reasoning in its Decision Notice is as follows:

Step 2: the seriousness of the breach

6.7 Pursuant to DEPP 6.5A.2G, at Step 2 the Authority determines a figure that reflects the seriousness of the breach. Where the amount of revenue generated by a firm from a particular product line or business area is indicative of the harm or potential harm that its breach may cause, that figure will be based on a percentage of the firm's revenue from the relevant products or business area.

6.8 The nature of Linear's business, relevant to the breach, is arranging and/or executing transactions in certain instruments directly for its clients. The Authority *considers the revenue generated from this business area is indicative of the harm or potential harm caused by the firm's breach. The relevant revenue is therefore the total revenue derived by Linear from this business area during the Relevant Period, which is £6,497,134.*

6.9 In deciding on the percentage of the relevant revenue that forms the basis of the Step 2 figure, the Authority considers the seriousness of the breach and chooses a percentage between 0% and 20%. This range is divided into five fixed levels which represent, on a sliding scale, the seriousness of the breach; the more serious the breach, the higher the level. For penalties imposed on firms there are the following five levels:

Level 1 – 0%

Level 2 – 5%

Level 3 – 10%

Level 4 – 15%

Level 5 – 20%

6.10 In assessing the seriousness level, the Authority takes into account various factors which reflect the impact and nature of the breach, and whether it was committed deliberately or recklessly. DEPP 6.5A.2G(11) lists factors likely to be considered 'level 4 or 5 factors'. Of these, the Authority considers the following factor to be relevant:

(1) The breach revealed serious or systemic weaknesses in Linear's procedures relating to a key part of its business.

6.11 DEPP 6.5A.2G(12) lists factors likely to be considered 'level 1, 2 or 3 factors'. Of these, the Authority considers the following factors to be relevant:

(1) There were no profits made or losses avoided as a result of the breach, either directly or indirectly;

(2) There was limited risk of loss caused to individual consumers, investors or other market users; and

(3) The breach was committed negligently.

6.12 The Authority also considers that the breach could have had an adverse effect on the market, in that it increased the risk that market abuse could occur undetected. Market confidence is put at risk if firms have ineffective systems and controls in place.

6.13 Taking all of these factors into account, the Authority considers the seriousness of the breach to be level 3 and so the Step 2 figure is 10% of £6,497,134.

6.14 Step 2 is therefore £649,713.

Step 3: mitigating and aggravating factors

6.15 Pursuant to DEPP 6.5A.3G, at Step 3 the Authority may increase or decrease the amount of the financial penalty arrived at after Step 2, but not including any amount to be disgorged as set out in Step 1, to take into account factors which aggravate or mitigate the breach.

6.16 The Authority considers that the following factor mitigates the breach:

(1) Upon becoming aware of the need to conduct its own post-trade surveillance in November 2014, Linear took steps to source and install an automated post-trade surveillance system in order to remedy the breach. Although it was not until 10 August 2015 that Linear had adequate risk management systems in place in relation to post-trade surveillance, and the breach therefore continued in the meantime, the delay in remediation was partly caused by unforeseen issues arising with the new system and so was not entirely within Linear's control.

6.17 Having taken into account this mitigating factor, the Authority considers that the Step 2 figure should be reduced by 10%. Step 3 is therefore £584,741.

Step 4: adjustment for deterrence

6.18 Pursuant to DEPP 6.5A.4G, if the Authority considers the figure arrived at after Step 3 is insufficient to deter the firm who committed the breach, or others, from committing further or similar breaches, the Authority may increase the penalty.

6.19 The Authority considers that the Step 3 figure of £584,741 represents a sufficient deterrent to Linear and others, and so has not increased the penalty at Step 4.

6.20 Step 4 is therefore £584,741.

Step 5: settlement discount

6.21 The Authority and Liner reached agreement during Stage 1 as to facts and liability by way of a focused resolution agreement (and, specifically, it agreed the matters of fact and liability contained in sections 2 to 5 of this Notice). Therefore, pursuant to DEPP 6.5A.5G and DEPP 6.7.3AG(1), a 30% discount applies to the Step 4 figure.

6.22 Step 5 is therefore £409,318.

Penalty

6.23 The Authority has therefore decided to impose on Linear, in respect of its breach of Principle 3, a total financial penalty of £409,300 (rounded down to the nearest £100, in line with the Authority's usual practice).

THE BASIS OF THE APPEAL

8. There are five grounds of appeal:

   Ground 1: the use of gross revenue figures in the Decision Notice as the foundation for the calculations is inappropriate and contributes to an entirely disproportionate result.

   Ground 2: the Decision Notice substantially overstates the seriousness of the case, resulting in a financial penalty far in excess of what the rules envisage.

   Ground 3: insufficient allowance is made for mitigating factors because (i) the mitigating factor which is accepted by the Authority justifies a reduction of more than 10%, and (ii) there were further mitigating factors to which the Decision Notice did not give any or sufficient weight.

   Ground 4: the penalty is disproportionate.

   Ground 5: the penalty is fundamentally inconsistent and irreconcilable with the approach taken by the Authority in the IB UK Final Notice (25 January 2018).

9. The points advanced by the Applicant directly affect only steps 2 and 3 of the five-step process. The Applicant's skeleton argument submits that the grounds reflect three basic points: that Linear's conduct was not as serious as the Authority contends; that there were mitigating circumstances which were initially ignored altogether by the Authority and subsequently given insufficient weight; and that the financial penalty is wholly disproportionate. The Applicant's case can therefore be summarised as being concerned with (1) seriousness, (2) mitigation, and (3) the overall result.

10. In the skeleton arguments and at the hearing there was some debate over whether the Applicant was departing from the terms of the FRA. The Authority contended that it was; the Applicant said it was not. Where there is any doubt over this, our approach is to interpret the Applicant's submissions and evidence in a manner that does not conflict with the FRA. We indicated this to the parties during the oral hearing. Accordingly, the 30% discount at step 5 remains in place. We do not consider it appropriate in this case to re-open any matter agreed in the FRA. It is common ground between the parties that the terms of the FRA do not prevent the Applicant from relying on additional facts which do not contradict the facts agreed in the FRA.

11. In support of the appeal we received the FRA, and written and oral witness evidence from Mr Kelly, Linear's CEO, and Mr Johnson, who was previously the compliance officer and is now a consultant to Linear, together with some additional

contemporary documentation. Our task is to consider the issues and the evidence and determine what is the appropriate action for the Authority to take: FSMA 2000, s 133(4), (5), (7), (7A). In accordance with Carrimjee v FCA [2015] UKUT 0079 (TCC), [15]:

> 'The Tribunal is not bound by the Authority's policy when making an assessment of a financial penalty on a reference but it pays the policy due regard when carrying out its overriding objective of doing justice between the parties. In so doing the Tribunal looks at all the circumstances of the case.'

12. Mr Kelly and Mr Johnson were cross-examined on behalf of the Authority. Their evidence filled out our understanding of the nature of Linear's business and therefore also of the context of Linear's breach of Principle 3.

13. It is convenient to take Ground 5 first, and then to take the other grounds in order.

GROUND 5: INCONSISTENCY WITH THE FINAL NOTICE IN THE IB UK CASE

14. Linear advanced a number of arguments which were said to support the proposition that the Decision Notice in the present case was inconsistent with the Final Notice in the IB UK case. But the Authority submits that there is no real inconsistency and that anyway each case must be considered on its own facts.

15. The Tribunal has examined the Final Notice in the IB UK case. In the Tribunal's view there are too many material differences in the facts of the two cases for the IB UK Final Notice to be a useful comparator. A particularly notable difference is that IB UK had post-trade surveillance systems in place, albeit they were insufficiently focused on the nature of the UK business. The Tribunal does not find the comparison to be of real assistance.

GROUND 1: USE OF GROSS REVENUE

16. At Step 2 of the DEPP procedure the Authority determines a figure that reflects the seriousness of the breach. Where the amount of revenue generated by a firm from a particular product line or business area is indicative of the harm or potential harm that the breach may cause, that figure will be based on a percentage of the firm's revenue from the relevant products or business area.

17. Linear's reference notice contends that it is not appropriate in this case to use revenue as a yardstick, because it is not proportional to the risk. But the Tribunal sees no merit in this argument. Revenue reflects both the number of transactions

and their size. As a broad starting point, the level of risk involved in a particular kind of business is likely to be proportional to the volume of business, other things being equal.

18. The FSA said in its policy statement of March 2010, reporting on the issues arising from consultation paper 09/19:

> … revenue will, in many of our cases, be a good indicator of harm or potential harm. We do not agree that profit is the most appropriate measure of harm, or potential harm, and it is difficult to attribute profit for a particular breach. We believe revenue is a more objective metric than profit as it does not require any calculation or attribution of costs to activities.

19. Linear submits that if revenue is used as a yardstick, it should be net revenue, not gross. Otherwise, a higher penalty would be imposed on Linear as a broker without DMA as compared to a broker with DMA who therefore has lower costs.

20. The Tribunal is not persuaded by this argument. There are many factors which affect the level of costs incurred by different businesses and their profitability. As the Authority rightly submits in its skeleton argument: 'There are many different business models and there are many reasons why net revenue or profit may vary widely, even between firms offering similar services. An overly nuanced approach to "relevant revenue" will diminish the transparency of the Step 2 process'. A broker without DMA suffers some costs that a broker with DMA does not incur, and saves other costs that a broker with DMA incurs. To embark on an exercise of departing from gross revenue on the basis of the details of a particular firm's business model would involve complexities that would effectively destroy the usefulness of adopting revenue as a starting point. Moreover, there is no reason to think that net revenue is a better reflection of the relevant risks than gross revenue.

21. The Applicant submits, in the alternative, that the use of gross revenue must remain subject to the overall judgment of proportionality in the circumstances of the particular case. The Tribunal agrees. In our judgment, this is the appropriate control on the bluntness of using gross revenue as a starting point. Particular circumstances may require an adjustment of the figure arrived at by applying the seriousness level percentage to the gross revenue. However, having heard Linear's argument and having seen the Applicant's filed accounts, the Tribunal is not persuaded that there is any particular feature which in this case makes the use of gross revenue inherently objectionable. Nor is the Tribunal persuaded that use of gross revenue leads in itself to a final result that is disproportionate in this case.

GROUND 2: SERIOUSNESS

22. The Applicant makes several criticisms of the Authority's judgment of the seriousness of the breach. For a number of reasons, Linear contends that this is a level 2 case, not level 3.

23. The percentages of revenue that are adopted, depending where a case is judged to sit from level 1 to level 5, are set out above. Paragraph 6.9 of the Decision Notice describes the range of percentages as a 'sliding scale'. This is something of a misnomer. Transition from one step to the next is a bumpy ride. An assessment that a case is level 3 rather than level 2 involves a doubling of the penalty. This consideration serves to highlight the importance of the judgment to be made on overall proportionality. In the Tribunal's view, to avoid injustice, it is necessary to consider where a case falls within the spectrum represented by a single level. If Case X at the lower end of level 3 is only a little more serious than Case Y at the higher end of level 2, plainly it would be wrong for the penalty in Case X to be double the penalty in Case Y.

24. In support of its contention that this case should be assessed as level 2 rather than level 3, Linear places particular reliance (i) on the absence of any contention by the Authority that suspicious transactions were not reported or that abuse in fact occurred, (ii) on the quality of the broker's surveillance, (iii) on the lower level of seriousness prior to October 2014 when LQ37 became an active client, (iv) on the error being negligent rather than anything worse, and (v) on Linear's active steps to put it right once it was appreciated.

25. The Authority's reasoning in assessing the breach as level 3 is set out in paragraphs 6.10-6.12 of the Decision Notice, as cited above.

26. The Decision Notice identifies as a level 4 or 5 factor that the breach revealed serious or systemic weaknesses in Linear's procedures relating to a key part of its business. The Tribunal fully agrees with this assessment. Linear's core business involved obtaining access to the market on behalf of clients so that they could participate in the market. Market abuse is a serious matter. To advance the regulatory objective of preventing or detecting market abuse, Linear needed to have in place a proper system of surveillance of its execution business. Multiple reminders of the importance of such a system were issued by the Authority or its predecessor the FSA. Linear failed to implement such a system from January 2013 to May 2015. In this period there were tens of thousands of trades per month. The limited manual oversight of transactions which took place was wholly inadequate. Linear had no other system of its own. Instead of fulfilling its surveillance duty, it left it to others to monitor the transactions, in particular Linear's broker.

27. The Decision Notice next identifies three level 1, 2 or 3 factors. The first is that there were no profits made or losses avoided as a result of the breach, either directly

or indirectly. This factor is repeated and endorsed in the Authority's formal Statement of Case on the reference (paragraph 49a). It may be wondered whether this reflects reality. It would be reasonable to suppose that Linear saved money by not implementing a proper monitoring system of its own. At the hearing before us, the Authority understandably sought to rely upon a statement made by Linear's counsel, on instructions, during the RDC hearing, concerning the costs of implementing a proper system. The Authority submitted to us that the penalty needed to be substantially higher than the costs saved.

28. However, Linear took objection to this line of argument, pointing out its inconsistency with the Authority's Statement of Case. Having seen this argument raised in the Authority's skeleton for the hearing, Linear served a supplemental note in response. It stated that reference to the figure mentioned at the RDC was-

> 'incomplete and unfairly prejudicial because, as was pointed out to the RDC, the figure excluded the costs of having manual oversight and potential savings with the broker through a service level agreement . . . and those costs or savings cannot be accurately quantified in advance of the Tribunal at this late stage beyond saying that the actual saving could well have been zero. However, since the issue of the potential saving does not form part of either side's pleaded case before the Tribunal and no evidence is led on the matter at all by either side then for the reasons set out above, it is submitted that the expenditure by Linear is not an issue which needs to be considered by the Tribunal.'

29. If this matter had been properly raised in the Authority's Statement of Case, the Tribunal might well have found it to be a highly material consideration. But it was not raised. The Tribunal accepts Linear's submission that it was raised too late and that Linear did not have a fair opportunity of dealing with it. The Tribunal therefore judges that, in the interests of justice, the Tribunal must consider the case on the basis expressly pleaded by the Authority, namely, that there were no profits made or losses avoided as a result of the breach, either directly or indirectly.

30. The next level 1, 2 or 3 factor identified in the Decision Notice is that there was limited risk of loss caused to individual consumers, investors or other market users. The Notice adds, however, that the breach 'could have had an adverse effect on the market, in that it increased the risk that market abuse could occur undetected.'

31. The parties agreed in the FRA that Linear's failure 'increased the risk that potentially suspicious trading would go undetected'. But the parties had differing views on the degree of risk. The Authority pleaded in paragraph 53 of its Statement of Case:

> '. . . the Applicant was in a significantly better position than the underlying brokers to carry out post-trade monitoring. By way of example, the underlying brokers did not have a relationship with the underlying clients or access to their

identity or other relevant information about them and, accordingly, could not effectively assess whether manipulative trading was taking place.'

32. In its Reply (paragraphs 32-34) Linear denied these allegations and made, in essence, the following points:

    1 Linear's broker operated an effective system of automated surveillance.

    2 The broker was aware of the identity of Linear's major client (referred to as LQ37) and of the nature of its business, and could see which trades were transacted by specific underlying trader clients of LQ37 by reference to unique identity and location numbers.

    3 A document which was only disclosed to Linear in unredacted form after the RDC hearing showed that the broker's system generated a modest number of alerts, which were competently followed up via Linear and subsequently closed due to appropriate mitigating evidence.

33. The Tribunal accepts that there is some degree of justification for these points, but only to a quite limited extent. So far as the evidence goes, the broker's approach to compliance was exemplary. But the broker's automated surveillance system cannot be regarded as having the practical effect of eliminating the risks flowing from Linear's failure to have its own system. The parameters of the broker's automated system were calibrated to the nature of the broker's business, not to the nature of Linear's business, which was significantly different. Accordingly, while it is correct that there is no contention by the Authority that suspicious transactions were not reported or that abuse in fact occurred, and this is an important feature, the Tribunal considers that the surveillance carried out by the broker, while useful in itself, has limited significance in the assessment of Linear's breach.

34. Linear's submission that there was a lower level of seriousness prior to October 2014 when LQ37 became an active client is correct, but this does not go very far in Linear's favour. In the six months up to September 2014 the executed trades averaged 19,000 per month; after LQ37 became an active client, this figure rose to 56,000 per month. Given the level of trading before October 2014, this is not an impressive point for Linear to make.

35. The third level 1, 2 or 3 factor identified in the Decision Notice is that the breach was committed negligently. As was agreed in the FRA, 'Linear was mistaken in its view held prior to November 2014 that the co-operation between themselves and underlying brokers was sufficient to meet their regulatory obligations.' Thus, it is common ground that the case is to be approached on the basis that Linear's breach was not deliberate or reckless.

36. It is right to say that Linear took active steps to correct the error once it was appreciated, but this took time.

37. The Tribunal must weigh all of these relevant factors in order to judge the level of seriousness. As indicated above, the Tribunal accepts only to a limited extent the points made by the Applicant. On the one hand this was a failure in an important area; on the other, there was no proven impact and the breach was not deliberate or reckless. In these circumstances the Tribunal agrees with the Authority that level 3 is the appropriate level of seriousness. The Tribunal was initially persuaded that the case fell only in the lower part of the range of level 3 cases but on further reflection the Tribunal does not adhere to this view. The negligence was of a serious kind and in relation to a serious matter. It was a key failing in the Applicant's business model.

38. Under step 2, the result of mechanical application of the percentage appropriate to a level 3 breach is a figure of £649,713. Given the Tribunal's view of this case, the Tribunal sees no sufficient reason to adjust that figure, and therefore adheres to it.

GROUND 3 – INSUFFICIENT ALLOWANCE FOR MITIGATING FACTORS

39. The mitigating factor which was accepted by the Authority was that the delay in remediation was partly caused by unforeseen issues arising with the new automated monitoring system and so was not entirely within Linear's control. For this, the Authority allowed a 10% reduction. Linear has not advanced any real argument for increasing this allowance for this factor.

40. Linear relies on several other factors which it says are additional mitigating factors which ought to be taken into account.

41. It says it held the belief that its broker was at all times carrying out sufficient surveillance. But in so far as this refers to the facts of what the broker was doing, this has been taken into account at Step 2. And in so far as this refers to Linear's negligent belief, this has also been taken into account at Step 2.

42. Linear says it took prompt steps to secure compliance. However, the Tribunal agrees with the Authority that this is not an additional mitigating factor. The timing of the remedial actions is reflected in the period of revenue considered by the Authority. In so far as there was an unforeseen delay in completing those remedial actions, this has been taken into account in the 10%.

43. Linear says it provided significant time and resources to address the issues with the third-party system which it bought in. But the Tribunal is not persuaded that this is an additional mitigating factor; it simply reflects the cost of Linear's compliance with its regulatory obligations.

44. Linear says that more recently other improvements have been implemented. The Tribunal is unable to see how this should count as a mitigating factor in relation to the breach.

45. The Tribunal finds no merit in Ground 3.

GROUND 4: THE PENALTY IS DISPROPORTIONATE

46. Applying the 10% mitigation reduction at step 3 to the Tribunal's step 2 figure results in a reduced figure of £584,741. At this level, the Tribunal does not consider that an increase for deterrence is required under step 4. Step 5 is the agreed 30% early settlement discount. Application of this discount results in the Authority's final figure of £409,300 (rounded down to the nearest £100).

47. Linear raises two points on proportionality.

48. The first point is that the size of the financial penalty equates Linear's conduct with more serious conduct of others when, in truth, it is not properly comparable. This submission relies upon the comparison with the Final Notice to IB UK. The Tribunal has rejected the usefulness of that comparison. This point therefore falls away.

49. Linear's second submission on proportionality is that the financial penalty, as set in the Decision Notice, amounts to 30% of net profit. This is said to be too much.

50. The Tribunal has considered this argument in the context of the Tribunal's findings. It is not a persuasive argument. As has already been stated, market abuse is a serious matter; the implementation of effective monitoring measures to prevent or detect it is similarly, therefore, a serious matter. No doubt the size of the penalty is painful to Linear, given its financial resources and level of profits. The Tribunal does not consider this to be inappropriate in the circumstances of the case. Ground 4 therefore fails.

CONCLUSION

51. The appropriate action for the Authority to take is to impose a penalty of £409,300.

52. Paragraph 39 of Linear's reference notice seeks an order that the Authority pay Linear's costs. The Tribunal considers that there are no grounds for such an order in this case; none were advanced by Linear. The Tribunal declines to make such an order.

Andrew Bartlett QC
Judge of the Upper Tribunal

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