M&G Investment Management Limited
Laurence Pountney Hill
London EC4R 0HH

Tel 020 7626 4588
www.mandg.co.uk

M&G INVESTMENTS

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By email: FEMR@bankofengland.co.uk

Dear Sirs,

Thank you for allowing us to respond to the consultation on the Fair and Effective Markets Review. We strongly welcome this initiative and appreciate having the opportunity to provide the Bank of England, the FCA and HM Treasury with our comments.

M&G is the European asset management arm of Prudential PLC and is one of the UK's leading asset management firms. As at 30 September 2014, we managed £257 billion in assets, including £158 billion in fixed income assets across public and private debt. Our expertise is built on over eighty years of investment knowledge and on our resources as one of the UK's largest active investors. Our team of over 250 investment professionals has been a key driver of our success and includes what we believe to be one of Europe's largest and most experienced credit research teams.

We are broadly supportive of the points raised in the Review and generally agree with the definitions of "fair" and "effective" that are proposed in the document. However, we would like to emphasize that transparency must be calibrated at an appropriate level, as clearly stated in section 3.3. Whilst we understand that the Review is not directly linked to the MiFIR discussions around pre- and post-trade transparency, we are concerned that these provisions – if not correctly defined and implemented – could risk sorely damaging liquidity in the European FICC markets. As a result, we urge the UK authorities to help ensure that the trade transparency rules achieve their desired result without negatively impacting these markets.

With regards to the specific issues raised in the Review, we would like to make the following comments pertaining to the Fixed Income and Currency markets:

Market Microstructure

Trading issues

Although we are favourably disposed towards the development of platforms, we feel that <u>any move to an exchange-based framework needs to be market-driven, not mandated by regulators</u>. Because of their extensive relationships, brokers will always be better suited to execute large transactions (where anonymity is required and trading may be spread out over several hours or days) as well as transactions in less standard instruments. Buy-side to buy-side trading in liquid instruments such as generic FX pairs in a larger size could potentially be envisaged, though this presents some practical problems. How would a firm such as M&G find out the positions of a potential counterparty and evaluate its credit risk, when such a buy-side firm is likely to be one of our direct competitors? Some type of intermediation would still be required; otherwise, we would effectively be pre-announcing to the market that we were looking to execute a potentially market-moving transaction.

Furthermore, on the subject of FX, we are of the opinion that barrier and digital options should not be embedded in retail products. There is little to no volume in these financial instruments, as sophisticated market practitioners do not generally use them. As a result, we question whether barrier and digital options are fully understood by retail investors and, as a result, are appropriate for such a clientele.

Finally, we are concerned about the decrease in liquidity in the Fixed Income market resulting from Solvency 2. The matching adjustment will oblige UK insurers to hold more bonds in relation to their annuities businesses. This will undoubtedly further decrease the liquidity of longer-dated Fixed Income assets, especially for maturities over ten years.

New issuance

We would welcome improved levels of disclosure regarding proposed new issues. Investors need to have adequate time to review a well-written and accurate prospectus, in order to ensure that they can adequately understand and price risk. There may be a role for regulators to stipulate minimum windows and levels of disclosure in order to facilitate this process. Increased disclosure of primary allocations could also be considered, notwithstanding the fact that investors, issuers and the effective market process could be disadvantaged if such a disclosure was overly granular.

Standardisation of new issuance terms is not a desirable outcome in our view. Issuers should be able to choose maturity and seniority according to their precise funding needs and not be subject to a pre-set list of terms and conditions which could increase their cost of borrowing. Participants in the corporate Fixed Income markets, which are mainly institutional investors, appreciate the diversification provided by this issuance pattern. Having standardised issuance terms could lead to a concentration risk for corporates, as well as create credit risk for investors. Additionally, given that most investors in corporate Fixed Income are buy-and-hold, having issues of a larger size due to standardisation would likely only provide incremental additional liquidity.

Furthermore, we believe that mandating Dutch auctions for new issuance would not be positive for issuers. Using Dutch auctions creates uncertainty around the price at which corporates can sell their bonds and issuance can still fail using this system. We note that the Debt Management Office used to exclusively rely on auctions ten years ago, and now uses a mixed model which includes debt syndication.

Competition and Market Discipline

Competition

We feel that competition in other markets cannot be compared to that of the Fixed Income and Currencies markets. For example, requiring Fixed Income market makers to have a firm commitment to trade the bonds that they underwrite (as with equities) would squeeze out SME issues and have a negative impact on liquidity. Capital requirements for trading have had a huge impact on banks' willingness to act as a market maker / participate in various market segments, and the treatment of equities is not the same as the treatment of fixed income assets or currencies.

Market discipline

Because of the wholesale nature of the FICC markets, we believe that buy-side firms can already effectively exercise market discipline in a number of ways. This could include discussions with senior management at a bank / broker, communicating with the regulator and, in extreme cases, filing a lawsuit. That being said, we acknowledge that such measures have, to date, been more successfully applied on an individual basis rather than collectively. We fully support the idea of forming EU-wide committees based on the IMA Special Committees, such that bondholders could discuss common problems relating to issuers and brokers.

Benchmarks

It is important to remember that asset managers are users of benchmarks, not administrators of benchmarks. When an asset manager manages a portfolio or fund against a benchmark, the choice of index is generally imposed upon it by the client (in the case of institutional investors) or by the fund's Board (in the case of funds). As many Fixed Income benchmarks are composed of thousands of issues which trade infrequently, if at all, asset managers often have minimal exposure to the large majority of bonds in the benchmark.

As benchmark users, we would greatly welcome a legally-mandated clarification of benchmark methodology, preferably via the EU's forthcoming Benchmarks Regulation. Many buy-side firms have difficulty in obtaining the information on indices required under ESMA's "Guidelines on ETFs and other UCITS issues". There has been considerable duplication of effort to obtain this information, with each firm individually requesting the same data from the index providers. Public clarification of the benchmark methodology would also help remove the conflict of interest within an investment bank which underwrites a bond and then de facto includes it in a fixed income benchmark that the bank administers.

Further governance and oversight around benchmark pricing should also be part of the EU Benchmarks Regulation. There are potential problems when an issuer is downgraded and its bonds are then mandated to move from the investment grade index to the high yield index. Should such bonds have no liquidity, it is not currently clear how the "market" price is determined to value the bonds during the transfer. For the FX fix and other benchmarks based on indicative data, the underlying data for the benchmark should be published, and there should be a clear audit trail. The Chinese walls between the contributors to such indicative data benchmarks and other traders should be assessed and improved where necessary.

Standards of Market Practice

With regards to Fixed Income, we strongly believe that there is value in an open forum in which buy- and sell-side market participants discuss the nuances of compliance and best practice. For example, the process of pre-sounding and wall-crossing is becoming increasingly prescriptive and less practicable, with further changes to be implemented because of the Market Abuse Regulation. Being able to discuss the "grey areas" in a safe harbour without concern for liability of misconduct would be most welcome. Should this be implemented, the regulator should be open to dialogue

with such forums, in the interests of clarifying their own interpretation of good, acceptable and bad conduct. We note the valuable tradition of the Bank of England as being approachable and open to such market engagement and would urge that this be applied across all regulatory bodies.

In our view, more individual professional standards would not sufficiently impact conduct. The FCA could consider training CF30s, but there is no guarantee that passing an exam would cause market participants to modify [potentially inappropriate] behaviour. Regulation alone will also not produce the desired outcome; instead, we recommend using the additional levers described briefly in the following sections.

Responsibilities, Governance and Incentive Structures

Robust and independent governance structures and processes - including the governance of remuneration - are a critical part of reinforcing a firm's commitment to good conduct standards. Compensation and incentive structures have a significant role to play in focusing staff on delivering performance in an appropriate way. Incentives should be designed to support / reinforce ethical behaviour with metrics reflecting financial, behavioural and risk and compliance parameters. Deferral of an element of any bonus paid and applying malus and/or clawback terms are effective ways of reinforcing a longer-term focus and ongoing accountability. Firms should be encouraged to apply these widely, though we would encourage a flexible approach to be taken in determining the appropriate vehicle for deferral. A move to team-based sales coverage and pooling of remuneration should be considered where appropriate. Such a change could potentially minimise the conflicts around information flow, such as those which were seen in FX.

Surveillance and Penalties

As the behaviour of senior staff informs the behaviour of junior staff, we believe that personal responsibility for wrongdoing in cases such as market abuse can help promote individual ethical behaviour. A realisation and acceptance of this personal responsibility is more likely to prompt behavioural change than the imposition of increasingly large bank fines which often inflict a greater punishment on end investors by diminishing their returns.

There also needs to be an accessible whistleblowing channel outside organisations, not just one inside firms. An internal channel can correctly serve its purpose in firms which are broadly promoting responsible behaviour; however, in certain circumstances it may be more effective to have an independent third party look into potential issues raised by employees and/or other market participants.

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In sum, we believe that there are many measures which can be undertaken that would help to improve the fairness and effectiveness of the FICC markets in the UK and beyond. We would be happy to meet with you and discuss this response in more detail.

Yours sincerely,

Simon Pilcher
Chief Executive Officer, Fixed Income