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The voice of banking

# The Fair and Effective Market Review

The BBA welcomes the opportunity to respond to the Fair and Effective Market Review's (FEMR) consultation. As the leading trade association for the UK banking sector representing more than 200 rmember banks operating across 180 jurisdictions worldwide, the BBA – with over eighty per cent of global systemically important banks as members – strongly supports FEMR's objective of ensuring that fixed income, cash and commodity markets remain fair and effective in their operation and outcomes, now and into the future.

## Executive Summary

Published on 27 October, the FEMR consultation builds on an extensive engagement programme undertaken by the FEMR Secretariat since summer 2014. The BBA and our members strongly welcome this open and proactive engagement and call on the Secretariat to continue consulting with key fixed income, foreign exchange and commodities (FICC) market participants as it develops its final recommendations in the months ahead. The BBA shares FEMR's objectives of ensuring that wholesale FICC markets serve participants, clients and end-users fairly and effectively, and – notwithstanding the already significant reforms which have been undertaken in these markets since 2008 – we agree that market structure and conduct vulnerabilities should be addressed through globally coordinated action.

The BBA firmly believes that maintaining trust in the functioning of FICC markets is paramount, especially as isolated incidents of FICC market misconduct continue to lead to negative and inaccurate perceptions of FICC markets and those who operate in them. Since 2008, the regulatory and legislative agenda in wholesale FICC markets has been dominated by far reaching and comprehensive reforms designed to promote greater market stability and increase transparency. FEMR's recommendations should build on these existing reforms, but also address impediments to greater market efficiency, especially as efficiently functioning global wholesale FICC markets are vital prerequisites for economic growth and effective capital allocation and distribution.

Our key recommendations are:

## Conduct

- **'Licence to trade' qualifications:** The BBA recommends that all persons undertaking activity in wholesale FICC markets should be required to become professionally qualified. Policy makers must work with the industry to both identify those existing industry qualifications that would constitute a 'licence to trade' and on the creation of a clear, well-defined and comprehensive 3rd country qualification recognition and equivalence regime.

- **Giving 'teeth' to codes of conduct:** The BBA recommends that agreed 'best practice' principles should be developed globally and then incorporated into existing industry codes. Amended industry codes that represent best practice should then be endorsed by regulators to give them 'teeth'. Demonstrated compliance with these codes (such as their integration into company and board mission statements, promotion prerequisites etc.) would constitute 'safe harbour' for firms.

- **Expansion of Individual Accountability Regime:** The banking industry is implementing the new Senior Managers Regime (SMR) as recommended by the Parliamentary Commission on Banking Standards. The BBA recommends that all relevant employees of all non-bank firms operating in wholesale FICC markets should be subject to either the senior manager or certification requirements as described in FCA CP14/13. This would encourage greater personal responsibility and accountability as well as a commonality of behavioural and organisational culture expectations.

## Market Structure

- **Fair and Effective Markets:** Whilst the BBA agrees with FEMR's definition of 'fair' and 'effective', the key question is how these concepts can be applied to FICC markets. In light of the professional character of wholesale FICC market participants, the BBA believes that FEMR's objective should be to ensure that market participants are in a position to accurately and satisfactorily draw their own conclusions as to whether they are being treated fairly and effectively.

- **A global approach:** The BBA believes that any reforms to the structure of wholesale FICC markets must be considered and agreed at a global level, perhaps led by IOSCO, whilst also taking into account their heterogeneous nature. Any initiatives should then be disseminated downwards and adopted by individual competent authorities where they must be implemented uniformly so as to reduce any possibility of market fragmentation and regulatory arbitrage.

- **No mandatory use of electronic platforms:** The structure and operation of FICC markets is evolving in response to a range of user, technological and regulatory developments. The migration of some types of trading to electronic trading venues is just one example of this evolution. Whilst electronic trading platforms do offer many benefits for market participants; the BBA does not support a regulatory requirement to mandate their exclusive use.

- **No mandatory standardisation of FICC instruments:** Whilst the standardisation of corporate bond issuance could bring some benefits to frequent issuers (and probably already exists

today to a significant extent), the BBA would not support a regulatory requirement to mandate the standardisation of issue size, issue date or maturity. Such a development would result in outcomes that are neither fair, effective nor responsive to the diverse needs of both issuers and investors.

- Support for Market Making: Since the 2008 global financial crisis, less liquid wholesale FICC markets have shown increasing signs of accelerating liquidity deterioration, bifurcation and fragility.[1] Accordingly, despite the greater use of electronic trading platforms, liquidity provision through the use of the traditional market-making model remains a vital activity that ensures fair and effective market outcomes for all market participants. It must be supported by policy makers.

- Existing reforms: Global wholesale FICC markets are the subject of significant reform in the form of EMIR, MIFID II, the Market Abuse Regulation, proposed EU and UK benchmarks legislation and the Dodd-Frank Act. Many of these reforms have not yet had sufficient time to bed-down whilst others (such as MIFID II) are still progressing through the EU's legislative processes. As such, the BBA believes that FEMR should not propose significant structural changes in these markets until the outcome of these reforms can be assessed.

## Competition

- FICC markets remain highly competitive: Whilst there has been some consolidation between market participants since the 2008 financial crisis, wholesale FICC markets remain some of the most competitive in the world. When considering FEMR's question as to whether FICC markets should be subject to a competition review, we note that only recently the Financial Conduct Authority (FCA) launched a competition inquiry into wholesale markets. The BBA recommends that FEMR defer to that inquiry and not initiate a new review until it has reached its conclusion.

- The importance of relationship banking: Relationship banking is a market feature which brings significant benefits to participants and end-users. Various important banking services and products could become considerably less cost-effective or available to participants if banks were unable to consider their trading relationships in a holistic manner.

## Benchmarks

- Benchmark reform is progressing quickly: The effective governance of the benchmarks price setting process is vital if potential market abuse associated with benchmarks is to be prevented. The BBA supports recent UK benchmark reforms including bringing the benchmark submission function within the scope of the proposed Certification regime. These reforms build on the already considerable progress made by industry in the wake of the Wheatley review. We note the pending release of EU benchmarks legislation, which will bring further reform to this area.

## Criminal Sanctions

- The UK criminal sanction regime is one of the most robust in the world. There already exists sufficient criminal sanctions to cover most, if not all, of the areas of market abuse subject to investigation over the last few years. These should be used deployed - there is no need for new criminal sanctions relating to CSMAD or generally.

[1] CGFS Papers no 52 *Market-Making and proprietary trading: industry trends, drivers and policy implications,* November 2014

## Questions

Q1: The Review would welcome respondents' views on the definition of 'fair and effective' FICC markets proposed in Section 3. Does it strike the right balance between safeguarding the interests of end-users without unnecessarily impeding the effectiveness of FICC markets? Are the concepts of transparency, openness and equality of opportunity appropriately specified? And how does the definition compare with those used in other markets, jurisdictions, organisations or legislation?

FEMR proposes to define 'effective' FICC markets as those which:

a) Enable market participants to trade at competitive prices; and
b) Allowing the ultimate end-users to undertake investment, funding, risk transfer and other transactions in a predictable fashion, underpinned by robust infrastructure.

FEMR proposes to define 'fair' markets as those which:

a) Have clear and consistently applied standards of market practice;
b) Demonstrate sufficient transparency and open access (either directly or through an open, competitive and well-regulated system of intermediation);
c) Allow market participants to compete on the basis of merit; and
d) Provide confidence that participants will behave with integrity.

Whilst the BBA agrees with FEMR's definitions of 'fair' and 'effective', as has been rightly identified in the paper the key question is how these concepts will be applied to markets which are heterogeneous, complex, global and utilised by a broad range of participants, both large and small, sophisticated and unsophisticated and regular and intermittent in their level of activity. Assessing wholesale FICC markets against this framework also asks considerable questions of regulatory regimes, particularly as most treat wholesale FICC participants differently to retail participants. For example, in the UK, whilst the 'fairness' of an outcome for a retail customer has historically served as a basis of regulatory intervention, such an approach is not commonly applied to a wholesale space dominated by professional and eligible counterparties. In wholesale FICC markets, regulatory change has trended towards stability measures, reforming information disclosure requirements, addressing data asymmetries, removing trading barriers and/or preventing market abuse. This approach is grounded in reality that whilst the ultimately beneficiaries of wholesale FICC markets are retail clients, given their different levels of sophistication there is a need for different protections for retail clients and FICC market participants (who generally are not retail although there are limited instances where some may have direct access).

Ultimately, the BBA believes that the measure of whether a market is fair and effective is whether market participants are in a position to effectively draw their own conclusions as to whether they are being served fairly and effectively given their needs, risk appetite and level of sophistication. Transparency which leads to this outcome empowers participants, builds trust and encourages market discipline. It also explains why different participants who are being charged different prices for similar services can all still be satisfied with their service and price offerings. We agree that there may be situations in which market participants are not in a position to reach an informed opinion, and that even then there may be situations where they are unable to act on their views. Accordingly, we believe that FEMR's recommendations should focus on measures which address these shortcomings rather than drawing specific conclusions as to which markets are 'fair' and which are 'effective'.

Transparency is a vital factor when considering whether wholesale FICC markets are fair and effective but transparency is not an end in itself. The desire for transparency must be balanced

against its impact on liquidity and the needs of users. When considering transparency, the BBA draws a distinction between market transparency (primarily aimed at price discovery), and regulatory transparency (which is necessary for market abuse prevention and the monitoring of systemic risk), noting that since the 2008 crisis a number of regulatory initiatives have been introduced aimed at expanding both, such as MIFID[2] I/II, EMIR[3]. The unintended consequences of some of these transparency reforms lead to questions as to whether introducing transparency in all situations necessarily results in positive outcomes. Accordingly, whilst the BBA supports greater efforts to introduce regulatory transparency, we do not believe that the measure of a market's market transparency should form the basis of whether that market is fair or effective. Instead, a fair market is one where transparency is balanced and adapted fairly to the needs of its users; where market participants possess enough information on which to make informed trading decisions, but on the other hand have their trading intention protected from being abusively exploited by others.

An additional factor when considering whether a market is 'fair' and 'effective' is its susceptibility to market abuse. This has been the focus of significant regulatory reform and is addressed further in question 48 and 49.

Q2: Of the six themes identified in Table A on page 5 market microstructure; competition and market discipline; benchmarks; standards of market practice; responsibilities and incentives; and surveillance and penalties), which do you consider to be the most important factors contributing to the recent series of FICC market abuses? In which other areas do you believe the fairness and effectiveness of FICC markets globally may be deficient? Do these answers vary across jurisdictions, or specific markets within FICC? Are there any other important areas of vulnerability that are not identified in the table?

The BBA believes that all of the above themes are important factors when considering contributory causes of market abuse. We observe that some of the sources of vulnerabilities (such as competition and market discipline) are more systemic in nature and would respond more readily to macro-policy responses rather than focusing purely on firms or individuals; regardless, the BBA believes that recent cases of FICC market abuse can be attributed to failures across a range of vulnerabilities.

When considering whether wholesale FICC markets are fair and effective, the BBA believes that there are two key questions:

a) Does the market work for its users?; and
b) Is the market structured in such a way that renders it excessively conducive to conduct vulnerabilities to the point that a) no longer applies?

The BBA is of the opinion that wholesale FICC markets operate effectively and meet the needs of their users. When considering whether wholesale FICC markets are structured in such a way that renders them excessively conducive to conduct vulnerabilities, the BBA believes that this generally this is not the case, although risks do exist. The aim should therefore be to reduce these factors as much as possible, although they will never be completely eliminated. Regardless, one clear conclusion which can be drawn from the most recent cases of FICC market abuse is that the role of management in promoting the 'right' culture is vitally important in preventing, detecting and addressing abuse.

[2] Markets in Financial Instruments Directive (MIFID)

[3] Regulation on OTC Derivatives, CCPs and Trade Repositories (EMIR)

In terms of other important areas of vulnerability, the BBA believes the issue of cross-border regulatory co-operation should be a key focus. As identified in the paper, wholesale FICC markets are global and diverse. There are numerous examples of inconsistencies in the regulatory approach of different jurisdictions which can cause market fragmentation, difficulty of application – especially in relation to the global markets – and increase the risks of regulatory arbitrage. This ultimately results in greater risks, higher costs to users, and negatively impacts on economic growth. Some examples are:

- EMIR equivalence requirements: Delays have created problems in relation to clearing requirements, extraterritorial application of the trade reporting obligation and intragroup exemptions. In some markets this has effectively shut out some EU participants due to local data privacy laws preventing EU entities from being able to report mandatory trade information as required under EMIR.

- MiFID II/MiFIR: Consistent with the equivalence requirements under EMIR, it is expected that any reciprocity requirements could create trading issues for EU entities;

- Bank Structural Reform: Uncertainties created by equivalence and reciprocity requirements in the current draft of the proposed legislation are deeply problematic for many participants;

- Financial Transactions Tax: The broad extraterritorial application of the proposed legislation is a grave threat to the fair and effective functioning of FICC markets; and

- Dodd Frank: "First mover" issues on clearing mandate, the SEF requirements, and trade reporting are all areas which would benefit from resolution.

Greater international coordination in the development and implementation of standards is key to addressing this problem. To that end, the BBA strongly supports the aims of the FSB as set out in its letter of 7 November to the G20; namely to promote a regulatory approach "based on co-operation, peer review and outcomes-based approaches to resolving cross-border issues". The need to build a system combining common international standards including deferral to each other's regulatory approaches where appropriate is vital.

Q3: Do trading practices involving barrier or digital options pose risks to the fairness and effectiveness of one or more FICC markets? How hard is it to distinguish between hedging and 'defending' such options in practice? Should further measures be taken to deal with the risks posed by barrier options, whether through market-wide disclosure of significant barrier positions, an extension of regulation or some other route?

The BBA supports and refers FEMR to the response by the International Swaps and Derivatives Association (ISDA) for further information on barrier options.

Q4: Does the market microstructure of specific FICC markets — including trading structures, transparency, asset heterogeneity or market access — enhance or diminish fairness and effectiveness? Where there are deficiencies, will recent or in-train regulatory or technological changes improve the situation, or are further steps needed? How do these answers vary across jurisdictions, or specific markets within FICC?

As noted in the paper, one common feature of a number of wholesale FICC markets is the role of 'internalisation', under which banks and other large dealers may give clients the option of executing transactions against their own book as principal. As observed, internalisation of transactions may in some cases result in better execution for clients because it allows them to trade at bid-offer spreads that are narrower than those available in the external market.

It is important to note that systematic internalisation is due to become subject to increased regulation from third January 2017, under MiFID II/MiFIR. Some of the key new rules that will apply will include a requirement for a firm to (in essence) provide firm, public, non-discriminatory quotes to clients where that firm systematically deals as principal in certain products (including bonds, structured finance products, emission allowances and derivatives traded on a trading venue) in its capacity as a systemic internaliser. There are certain exceptions and qualifications to this, including:

- RFQ basis of regime: The fact that the obligation only applies where a firm is prompted for a quote by a client of the SI and agrees to provide the quote (Article 18(1) MiFIR);

- Products for which there is not a liquid market: Where there is not a liquid market in the relevant products, firms will only be required to disclose quotes to clients on request and only where they agree to provide a quote (Article 18(2) MiFIR);

- Updating and withdrawing quotes: That quotes may be updated at any time and withdrawn under exceptional market conditions (Article 18(3) MiFIR);

- Access to quotes: Firms may choose not to give access to SI prices to a client on the basis of their commercial policy, provided that this decision is objective and non-discriminatory (Article 18(5) MiFIR);

- Limits on number of transactions that can be entered into pursuant to any quote: Firms are permitted to establish non-discriminatory and transparent limits on the number of transactions they undertake to enter into with clients pursuant to any given quote (Article 18(7) MiFIR); and

- Price improvement: Firms may execute orders received at a better price than their current SI price for the relevant product provided that the better price falls within a public range close to market conditions (Article 18(9) MiFIR).

Whilst it will be important to ensure that any proposals following the FEMR review do not duplicate or disrupt any of the initiatives already underway under MiFIR or its accompanying Directive, the FCA is of course a key stakeholder in the European Securities and Markets Authority (ESMA) and was closely involved in those reforms. With this in mind, work by the UK authorities under the auspices of the FEMR review may be of assistance to ESMA and other European authorities in helping to implement and interpret the internalisation requirements under MiFIR, provided it is properly coordinated with the European-level work in this area.

In this context, one area that may require further examination is how best to reconcile the exceptions to the systemic internaliser obligations with the need to ensure that markets are fair and effective for users. For example, whilst many firms currently tier the prices they provide to clients for dealing as principal in some products (e.g. FX and credit products), this may not be for the purpose of preferring some clients over others, but rather to prevent competitive prices provided to genuine,

corporate and buy-side clients being arbitraged by other proprietary or professional traders (e.g. other financial institutions and hedge funds). In this way, exceptions to the obligation to provide standardised, internalised pricing are not inconsistent with the principle of best execution; on the contrary, they may be crucial in ensuring best execution results for genuine users of markets, since a blanket requirement to provide standard pricing would require firms to price defensively, leading to a reduction in the competitiveness of prices provided to genuine users. For example, recognising that firms are permitted to prioritise orders from genuine corporate and other buy-side clients under the non-discriminatory and transparent limits that may be put in place under Article 18(7) of MiFIR may assist in ensuring that the new rules on internalisation of orders do not undermine the fairness or effectiveness of the relevant markets for end users.

Similar considerations apply to the practice of 'last look' referred to on page 25 of the paper, which gives market makers the right to accept or reject a trade immediately prior to acceptance. The right to exercise a last look may be to prevent arbitrage of prices by other proprietary or professional traders and therefore prevent the need for defensive pricing, rather than simply to avoid potentially unprofitable trades; firms with a right of last look may in fact choose to honour unprofitable trades with corporates and other genuine market users. In our view, any new rules or guidance on the use of last look or other similar practices should consider how such practices can be used to ensure the best execution results obtained by clients. Such practices should not be subject to an outright ban or otherwise be seen as being inconsistent with clients' best interests in all circumstances.

Q5: Is greater use of electronic trading venues for a wider range of market participants possible or desirable? Are there barriers preventing a shift to a more transparent market structure?

The BBA notes the increasing trend of FICC trading migrating to electronic trading platforms. It is the view of BBA members that this trend is likely to continue thanks to the ability of electronic platforms to offer more efficient cross-market connectivity and improved functionality such as automated trade matching and straight-through processing. Regulatory factors are also driving this change, with banks that traditionally performed FICC market-making functions now subject to more demanding capital requirements as a result of the implementation of Basel 2.5 via the EU's Capital Requirement's Regulation and Directive. This resulting decrease in the number of banks electing to perform a market making function is also a factor in the increased use of electronic trading platforms.

It is worth noting that this increased utilisation of electronic platforms is coming from a relatively low base when compared to equity markets[4]. Despite their increasing use, the BBA does not believe that electronic trading platforms will completely subsume the role of non-electronic platform market-making. Indeed, existing electronic platforms tend to be used for only a limited range of typically standardised and often smaller size transactions for which a sufficiently large number of orders can be matched on a regular basis[5]. The BBA references the International Capital Market's Association (ICMA) where it notes that while 40% of European investment grade corporate bonds are traded on platforms, these are primarily small trades; in general, larger tickets sizes continue to be executed via brokers using phones.[6]

There are a number of challenges associated with electronic platforms which can explain this pattern, not least of all transparency requirements that limit the willingness of investors and dealers to execute trades electronically for fear of revealing their trading strategies, or the scattered order flow of corporate bonds which does not lend itself readily to the operating models of many electronic platforms[7]. Accordingly, the BBA supports ICMA's conclusion that trading behaviours current in the

[4] CGFS, op. cit. p22

[5] ibid

[6] ICMA, January 2015, Fair and Effective Market Review Consultation Document: ICMA Response, pp3.

[7] ibid

market are likely to persist, especially where market participants are dealing with bespoke or illiquid securities or where concerns over inappropriate price transparency dictate non-electronic platform trading strategies. Depending on what post 2017 landscape, pushing unsuited and inappropriate illiquid products onto electronic venues may be neither possible nor desirable in times of market stress.

From a conduct perspective, there is no empirical evidence that conclusively demonstrates that electronic trading is vastly more impervious to conduct risk than non-electronic trading methods. Indeed, whilst it is true that e-trading may lend itself more readily to electronic recording keeping, the creation of audit trails and various automated forms of surveillance, it can also create new risks (such as those associated with high frequency trading strategies) which can lead to questions of fairness. There is also no empirical evidence that the agency model of intermediation is any more 'cleaner' than the principle-to-principle model; these two structures both involve conduct risks, and no model is inherently preferable to the other.

There are additional reasons why a market completely traded on electronic platforms may not be desirable:

- Electronic platforms tend to be anonymous: In a crisis, experience has shown that counterparties will look to trade with individuals they know and trust, such as a recognised market maker. In times of particular market stress, markets need to have a range of voice, bilateral and electronic trading options acting as shock absorbers to avoid trapping pockets of liquidity. In practice, BBA members have advised that individuals have been shown to be hesitant to trade on electronic platforms during periods of extreme volitility. The most recent example of this phenomenon being the market turmoil following the Swiss National Bank's decision to no longer support the franc against the euro.
- Not all participants can access an electronic platform: Exclusive electronic trading could exclude both professional and retail clients from access to the FICC market. This may lead to questions about fairness. Similarly, where counterparties chose not to use an electronic market, they may also face a disadvantage as they will receive a less advantageous price due to liquidity fragmentation. As an example, under MiFID II counterparties can voice-trade in bonds, however the quote must be made publically available within five minutes. This may result in market makers simply choosing not to offer this service as it requires technological infrastructure which might not always be either feasible or cost-effective. This is particularly true in cross border markets.

Electronic trading carries its own inherent risk that needs to be managed, and whilst much is to be welcomed about the move towards electronic trading, market participants and regulators need to fully understand the operational and liquidity risks associated with its growing adoption. Other risks may include business continuity considerations (e.g. cyber-attack, infrastructure resilience) data security considerations, and liquidity impacts.

Finally, the BBA notes that MiFID II/MiFIR is yet to be fully implemented, with key regulatory technical standards currently subject to an ESMA consultation. Under MiFID II/MiFIR, greater transparency will be brought to both the operation of electronic platforms and their authorisation. The BBA firmly believes that these reforms should be implemented and their impact assessed before any further reform of electronic trading requirements is considered.

Q6: Is standardisation of corporate bond issuance possible or desirable? Should standardisation be contemplated across a broader range of fixed income products? How could that be brought about?

When considering whether greater standardisation is possible or desirable, the BBA believes that standardisation – regardless of instrument type – must not come at the expense of the effective functioning of markets. Similar to transparency, standardisation is not an end in itself; markets must still serve the needs of their users effectively and efficiently.

In that vein, whilst standardisation of bond issuance could bring greater market efficiencies for large and frequent bond issuers, the BBA does not believe that mandatory standardisation of either issuance date, issuance size, coupon payment dates or maturity date would result in a more fair or effective market. Instead, mandatory standardisation could have a detrimental impact on the ability of the market to effectively serve the need of all its issuers – regardless of their size – by reducing the ability of small and medium sized enterprises to access effective, efficient bond markets.

The BBA believes that standardisation of bond issuance would fail to meet the needs of issuers by:

a) Removing the flexibility of issuers to respond to a reverse enquiry request from an investor. This also reduces the ability of investors to tailor a bespoke product to suit their specific investment needs.
b) Removing the flexibility of issuers to tailor their bond's maturity and coupon profiles to match their own required funding profile. This is particularly pertinent in the case of issuers looking to fund specific, bespoke projects with irregular cash flows.
c) Increasing costs for investors as issuers look to recoup this loss of flexibility through increased pricing of their bonds.
d) Adding market and refinancing risk due to large volumes of bonds maturing at the same time. This could distort the market as issuers seek to roll-over or redeem significant quantities of securities within narrow time-frames, potentially inducing not only refinancing, liquidity and operational risk for those participants, but also opening the market to greater risk of abuse and manipulation;
e) Shutting out smaller and medium sized participants from the market if they are unable to issue sufficient volume of debt. There is also no guarantee in any event that investors in such instruments would choose to trade these bonds in such quantities as to enable a liquid secondary market, as opposed to holding them.

The mandatory standardisation of bonds may also run contrary to the objective of the European Commission's Capital Markets Union initiative which – judging by the initial commentary of senior European Commission and Parliamentary policy makers – is focused on deepening the EU's capital markets in order to lower the cost of capital and improve allocation. Whilst there may be some benefit in standardising documentation around bond issuance (similar to the requirements of the EU's Prospectus Directive), the BBA believes that this would not by itself be a significant factor in driving the development of deeper corporate bonds secondary markets.

In regards to derivative markets, the BBA supports the submission made by ISDA. We support its conclusion that there already exists significant standardisation across both credit and interest rate derivative markets, a trend which is likely to increase in the medium term in response to regulatory, technological and market factors.

Q7: Should the new issue process for bonds be made more transparent through the use of auction mechanisms, publication of allocations or some other route?

The BBA supports and refers FEMR to the response by the ICMA for more information on the use of alternative mechanisms for placing bonds in the market. We note and support their conclusion that following the financial crisis, imbalances in the market have come not by any systemic shortcomings; rather they have arisen due to the marked increase in demand for Eurobond that has not been matched by the parallel increase in supply. Consultation with issuers has also confirmed that as corporate borrowers have a strong interest in identifying which investors may participate in their primary issuance, they generally choose not to issue by auction, even if an auction confers on the borrower some pricing advantage for the transaction in question. We believe that mandating specific mechanisms – as opposed to letting issuers chose the issuance route – would reduce choice and result in a less effective market for investors and issuers.

Q11: Are there any areas of FICC markets where regulatory measures or internationally co-ordinated regulatory action are necessary to address fundamental structural problems that exist?

As acknowledged by FEMR, FICC markets are complex interrelated systems where regulation and market practice can interact to produce unintended consequences. This is especially so when international factors are taken into account, the most significant of which is the way in which regulatory regimes apply to market participants operating across multiple jurisdictions. Accordingly, it is important that when implementing market change – whether through regulation or via industry-led means – the overall impact on the financial eco-system is considered, not just its impact on a specified sub-set of participants. Regulation that creates barriers to new participants entering a market or which unequally burdens existing participants must be avoided.

There have been several examples where the failure to properly consider international factors when introducing legislative and regulatory reform has had a material impact on the effectiveness of FICC markets. The BBA believes these areas would benefit from further consideration as inconsistent approaches to the scope and application of regulatory initiatives have created issues of fragmentation, application and potential for regulatory arbitrage, and impeded the effectiveness of markets. Some examples are:

- EMIR equivalence requirements: The lack of regulatory convergence following the 2009 G20 OTC clearing commitments has created problems in relation to clearing requirements, extraterritorial application of the trade reporting obligation and intragroup exemptions. The combination of a lack of third-country CCP recognition and the expiry of the transitional provisions related to own funds for exposures to CCPs in the European Capital Requirements Regulation is particularly pertinent as EU banks and investment firms would not be able to apply qualifying CCP capital treatment to CCPs not recognised by the ESMA. In regards to trade reporting, the failure to coordinate globally has seen some foreign jurisdictions - South Korea, for example – effectively shut to EU participants thanks to local data privacy laws preventing EU entities from being able to report some trade details as required under EMIR.
- MiFID II/MiFIR: Consistent with the equivalence requirements under EMIR, it is expected that any reciprocity requirements could create trading issues for EU entities;
- Bank Structural Reform: Uncertainties created by equivalence and reciprocity requirements in the current draft of the proposed legislation are deeply problematic for many participants;

- Central Securities Depositary Regime: Article 5 (on T+2) which, unintentionally, potentially prohibits the trading of some securities financing transactions on electronic repo-trading platforms.
- Financial Transactions Tax: The broad extraterritorial application of the proposed legislation is a grave threat to the fair and effective functioning of FICC markets; and
- Dodd-Frank: "First mover" issues on clearing mandate, the SEF requirements, trade reporting are all areas which would benefit from resolution.

As cited by FEMR, moves to expand regulatory scope into unregulated markets would require considerable global effort. The BBA notes that many aspects of FICC markets are already subject to national or regional regulatory intervention where implementation has been handled poorly and problems have arisen. This does not bode well for any new proposals, especially as FICC markets are global in scale.

## Collateral

Reforms since the 2008 crisis have placed an added emphasis on the use of collateral as a measure to the ensure safety and soundness of financial markets, with examples being EMIR and the exchange of margin for non-centrally cleared derivatives. Although the use of collateral is not new, its expanding usage creates both opportunities and risks for markets, especially where collateral chains cross jurisdictions and could be subject to separate insolvency regimes in the event of default. Policy makers must not impede this flow of collateral and work with markets to improve the efficacy and transparency of its flow around the system. We note the concerns of many market participants as to constraints on the availability of high quality collateral during times of market stress and the potential implications that may have on price.

## Market Making

Vital to the fair and effective functioning of wholesale FICC markets is the role of market makers. This is an activity which has been the subject of considerable change, the drivers of which are well articulated in the Committee on the Global financial System's (CGFS) *Market-Making and proprietary trading: industry trends, drivers and policy implications* paper, where it notes:

- Diverging liquidity trends
- Decline in dealer risk taking willingness
- Increasing differentiation and greater focus on core markets; and
- Growing and more concentration demand for immediacy services.

A key factor driving these changes is regulation impacting the ability of banks to make markets across a range of FICC and non-FICC products. For example, whilst the BBA agrees with the overall objective of the net stable funding ratio (NSFR) to require banks to maintain a sustainable funding structure and to reduce funding risk over an extended time horizon, the calibration of this tool is causing serious concern, especially given the moves that banks have already made to improve the funding structure of their balance sheet. It may be argued that the changes might have a modest aggregate impact, however in terms of specific business lines the impacts are very significant and may lead to a reduction in activity or even exits in certain important areas.

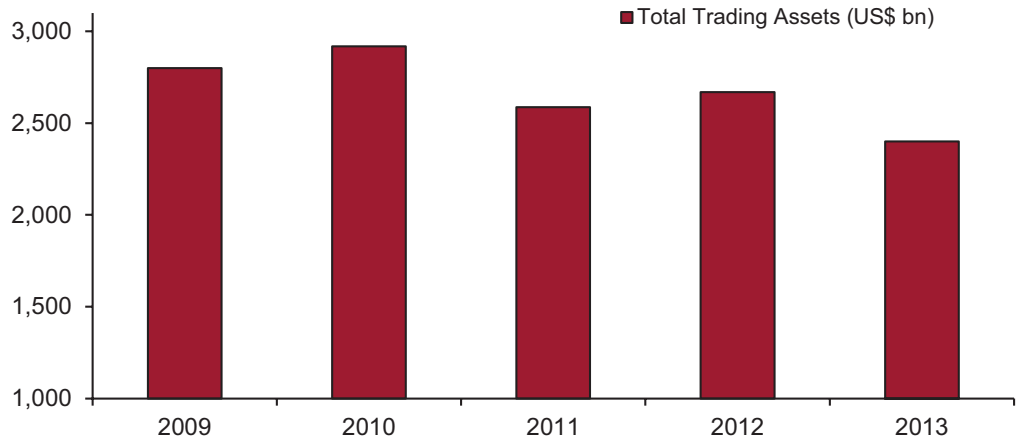
Overall the BBA believes that the effects of the NSFR will increase customer costs, see the funding market shift from banks to non-banks, reduce liquidity in fixed income markets with the potential for

increased volatility and increase the costs of hedging thus again raising the cost of capital. Significant increases in funding costs for equity market making as a result of stable funding requirements will hinder the ability to offer many products, especially where there is a use of derivatives markets to hedge risk (for example, total return swaps) is rendered uneconomic due to new regulations.

For example, in regards to OTC derivatives, the changes to the credit valuation adjustment (CVA) capital charge has made a number of long dated derivatives markets uneconomic from a market makers perspective. This has meant a significant reduction in the duration of many banks' derivatives books. Given the need to ration the use of balance sheet and regulatory capital, some firms have exited less liquid or peripheral markets in response.

Evidence of this pattern is already becoming clear. Research conducted by Credit Suisse[7] shows that total trading assets of the largest ten US and European banks have fallen by 17% from their peak back in 2010. Rates business has been hit particularly hard with assets down by a third. The research shows how under this new regime, dealer balance sheets will be less able to function as safeguards of liquidity, with balance sheets becoming less responsive to large selling on behalf of the buy side. The concern is that whilst this is not an issue under current market conditions, should markets come under stress, the market may see significant price moves and an explosion in volatility. In particular, the incentives of non-bank providers of liquidity in these markets may not be aligned to support the provision of stabilising liquidity during times of market stress.

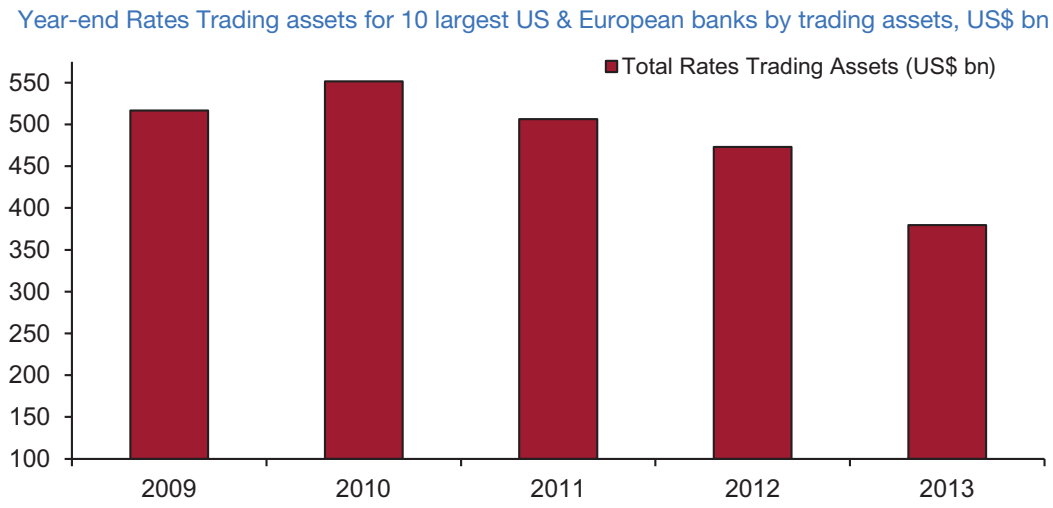
Year-end FICC and Equity Trading Assets for 10 largest US & European banks by trading assets, US$ bn




Source: Credit Suisse estimates, Company reports

Figure 1: Trading Assets have been trimmed 17%

[8] Credit Suisse Fixed Income Research, Downside of Prudential regulation: Lower liquidity May 2014




Source: Credit Suisse, Company reports

Figure 2: Rates trading assets have fallen by one third

Should these trends continue, the implications are upward pressure on trading costs, reduced market liquidity in secondary markets and potentially, higher costs of financing in primary markets. All of these represent poor outcomes for participants, end-users and the wider economy. We support the CGFS when it calls for policy makers to support initiatives to raise the probability of achieving more appropriate prices and robust liquidity conditions, and to consider possible backstops to address vulnerabilities which could arise under adverse scenarios[9].

The reduced ability of banks to act as a liquidity buffer in some markets has proved a threat to fair and effective markets for all but the most liquid markets. Unless properly calibrated, the proposed MiFID II/MiFIR pre-and-post trade transparency rules will deepen this problem, especially as it would be hazardous to enforce controls suitable for agency models on a principal-risk taking world. In regards to equity trading, it can be largely assumed there is a liquid underlying market and buyers and sellers can be quickly matched; in most areas of FICC, there is less liquidity, a narrow range of investor motivation (e.g. buy-and-hold/secondary market activity) and as a result there may be long times between matching buyer and seller interests. Intermediaries will continue to be needed in order to warehouse this risk. The BBA calls on policy makers to consider what steps could be taken to support market making, and not create further barriers to this important activity.

Q12: Where do potential conflicts of interest arise in the various FICC markets, and how do they affect the use and potential abuse of confidential information, both within and between firms?

The BBA notes FEMR's analysis that conflicts can exist in FICC markets. Specifically, the BBA believes that conflicts of interest may arise where:

- a participant is trading for its client whilst at the same time undertaking proprietary trading;
- there is potential for the abuse of confidential information for the participant own gain;
- there is a benefit brought through collusion with other market participants;

[9] CGFS Papers no 52 *Market-Making and proprietary trading: industry trends, drivers and policy implications*. November 2014

- a participant has multiple roles e.g. with respect to the administration, input to and use of benchmarks; or
- there has been a failure of internal measures to monitor business lines which must remain separate.

Q13: How can the vulnerabilities posed by such conflicts be reduced? Are existing internal structures and control procedures sufficient? Where they are not, are further internal management controls required (such as better trading floor design and/or closer monitoring of electronic communications within and between firms) or is more radical action required to remove conflicts altogether?

The BBA believes that the EU's Market Abuse Regulation (MAR), MiFID, MiFIR, the FCA's principles for business, existing UK legislation and appropriate remuneration policies within firms are all effective tools in managing conflicts of interest. EU legislation such as MAR, MiFID and MiFIR strengthens the framework around insider dealing and market manipulation whilst implementing a single market abuse rulebook across the EU. MAR in particular brings within scope instruments traded on organised trading facilities plus emissions allowances and commodities, and also prohibits certain algorithmic and high frequency trading strategies including layering, spoofing and quote stuffing as forms of market manipulation. Not only does EU legislation stipulate internal control measures to manage conflicts, as well as surveillance and reporting requirements, but Principle 8 under the FCA's Principles for Business enforces management of conflicts of interest between firms in a fair manner. Moreover, SYSC 10 within the FCA handbook addresses the requirement to identify and manage conflicts. This also includes specific reference to SYSC 10.2 – Chinese Walls; which addresses the internal control aspect with and between firms. Finally, individuals have additional protection under the *Public Disclosure Act 1998* which requires conflict of interest incidents to be reported. This legislation acts across all industries.

In regards to intra-firm controls, conflicts of interest policies should reference how conflicts are managed between group entities. Remuneration policies also have an important role to play, with payment assessment metrics promoting and rewarding of conduct which reveals conflicts and challenges poor practices. Within banks, the physical separation of trading desks has long been one of many tools to manage potential conflicts of interest, with others including separate reporting lines, more targeted surveillance and clearer management responsibilities for managing these conflicts. Whilst these are not always appropriate or necessary in every situation, they serve as some of the many examples of steps that banks have taken in order to manage and reduce risk.

Q14: Is there a relationship between the level of competition in FICC markets globally and the fairness and effectiveness of those markets? What risks are posed by the increase in concentration seen in some FICC markets? In answering this, please have regard to the geographical scope of any relevant markets.

Effective competition in wholesale FICC markets is vital if markets are to be considered fair and effective. Competition offers users choice of both counterparty and product offering, can lead to narrower pricing spreads (although this can be equally dependent on product type) and a strengthening market discipline as service providers strive to attract and retain clients. Conversely, competition can also lead to market and liquidity fragmentation, a situation which can lead to increased costs as economies of scale are eroded.

The BBA agrees that a concentrated market can pose risks to the fair and effective functioning of

markets. In its recent review into competition in the wholesale sector, the FCA argued (and the BBA agrees) that the risks arising from an overly concentrated sector largely include:

- Exploitation of market power, especially where one or more firms have a strong position on a market and are able to exploit their clients or exclude their rivals;
- Exclusionary behaviour that may include practices which make it difficult for less established players to compete;
- Barriers to entry or expansion where it is difficult to enter a market or grow rapidly, and where existing players are protected from the threat of someone else coming in offering a cheaper or better service. The FCA acknowledged that regulation can itself be a significant barrier to entry in this regard; and
- Barriers to switching, where clients, once signed up with a particular supplier, find it difficult or costly to take their business elsewhere[10].

Wholesale FICC markets in the UK remain some of the most competitive markets in the world and are a key component in London's success as a global financial centre. Despite the slight increase in concentration of market participants, since the 2008 crisis, there is no evidence that any of the above risks have manifested themselves to a systemically significant degree. Neither is there evidence that wholesale FICC markets are overly dominated by large participants to the detriment of the wider market; in fact, the increase in concentration has not come from predatory behaviour by large players, but from a withdrawal by some participants from traditional FICC market activities such as market making. This has occurred due to more onerous capital requirements and difficult trading conditions. Any failure of new entrants to enter these markets has largely been driven by similar factors.

Q15: To the extent that competition is currently ineffective in any of the FICC markets, are there market-led initiatives, technological or structural changes that may remedy this situation?

While the BBA does not believe that competition is ineffective in FICC markets, there are a number of regulatory and market-led forums where technological and structural impediments to the fair, effective and efficient functioning of FICC markets are regularly and expertly addressed. Bodies include the Bank of England and the FCA, the BBA, ISDA, ICMA, the Global Financial Markets Association, Future Industry Association, the Investment Association, and the Association of Corporate Treasurers. We would urge the Secretariat to engage proactively with these and other forums when drafting its recommendations.

Q16: Are there any lessons that can be drawn from experiences in other financial markets (or indeed other markets) about the ways that alternative or evolving market structures could impact on competition in FICC markets?

Yes. It has been widely acknowledged that following the introduction of mandatory swap execution trading facility in the US in 2014, global OTC derivative markets have undergone significant fragmentation with many participants that traded with US counterparties amending trading behaviour so as to avoid doing so. Other examples include delays to the recognition of third country regimes under EMIR potentially causing participants to withdraw from foreign infrastructures (such as CCPs), and instances where trade reporting requirements which are incompatible with foreign laws resulted in a cessation of trading in those markets.

[10] FCA, Wholesale Competition Review – call for inputs, July 2014. pp11

These examples show the importance of global regulatory convergence; of working not only with foreign regulators to understand their regimes, but also with participants who operate in those markets in order to understand how changes will affect market behaviour. The BBA has long advocated a greater role for international bodies such as IOSCO to set rules and guide regional implementation in this process. We believe that principles agreed at that level should then be incorporated by UK and EU legislators in primary legislation, ingrained with sufficiently flexibility to allow ESMA and national competent authorities to respond to market specific issues as they arise. IOSCO would stay involved in this process and advocate for solutions which promote global coordination, with ESMA legally empowered to act on those recommendations where appropriate.

Q17: How effective is market discipline in enforcing sound market practices in each of the key FICC markets? What could be done to strengthen it?

Competition is the key to effective market discipline and in this regard the BBA believes that wholesale FICC markets are relatively healthy. Participants who trade in highly liquid products are able to choose from a wide range of FICC product and service providers across a wide range of markets. We refer the FEMR Secretariat to ICMA's response for further detail on specific bond market developments that have benefited from market discipline.

For smaller clients, it is more common to trade with a more restricted list of counterparties. This is because many small market participants may choose to access markets via an intermediary chain whilst utilising an already existing broker/banking relationship. In regard to banks, this approach may arise because a bank already holds security over some assets which can serve as collateral. Even in these cases, clients are able to take the relationship elsewhere should they wish to do so.

Relationship banking offers important benefits to the market. Banks will most commonly add to their service offering by:

- Providing tight prices on certain market products (vanilla derivatives or government bonds) so as to obtain more profitable business on more complex products or Debt Capital Markets business at a later time; and
- Providing access to their balance sheet on expectation that other more profitable trading business will also follow.

Without relationship banking basic banking services could become much more expensive, leading to greater concentration and cost. Indeed, the detachment of execution from the client relationship would likely worsen the pricing available to the clients, especially where competition or market discipline is restricted. For example, it is possible that UK money market funds will soon only be able to hold certificates of deposit issued by one major bank. The only way this could realistically be resolved would be to allow money market funds to hold lower rated paper.

Q18: In what ways might competition in any of the key FICC markets usefully be addressed by competition authorities (e.g. by assessing the state of competition in relevant markets)?

We note that in October 2014 the FCA launched a public consultation into competition in wholesale markets. The BBA recommends that FEMR defer to the results of that consultation when considering this question.

Q19: Are there any additional regulatory reforms that could be helpful in promoting competition and market discipline in FICC markets?

We note that in October 2014 the FCA launched a public consultation into competition in wholesale markets. The BBA recommends that FEMR defer to the results of that consultation when considering this question.

Q20: Is there a need for better awareness and understanding of the existing competition framework among FICC market participants, both at firm and individual level? How do you think that might be best achieved?

We note that in October 2014 the FCA launched a public consultation into competition in wholesale markets. The BBA recommends that FEMR defer to the results of that consultation when considering this question.

Q21: Do current domestic and international initiatives by industry and regulators to improve the robustness of benchmarks go far enough, or are further measures required?

The effective governance of the benchmarks price setting process is vital if the recurrence of potential market abuses associated with benchmarks is to be prevented. The BBA supports UK benchmark reforms which build on the already considerable progress made by industry in the wake of the LIBOR reforms. We also note that legislation regulating benchmarks is currently making its way through the EU's legislative processes, although we do have concerns around proportionality (i.e. what should apply to a benchmark such as LIBOR, versus a benchmark available to/used by a much smaller group), and potential extra-territorial application. Finally, we note HM Treasury's recent announcement that it would be bringing seven additional systemically important benchmarks within the scope of UK legislation, and benchmark submitters are now also likely to be included in the scope of the certified persons' regime.

In light of these recent and pending developments, we do not believe that further action in regard to benchmarks is required.

Q24: Should there be an industry panel to discuss benchmark use and design with the aim of assisting industry transition?

The BBA supports continued engagement with market participants to improve the use and design of benchmarks with a view to harmonising best practices. The BBA supports this panel initiative in principle and believe it should include cross-industry and cross-border stakeholders. Further consideration should be given to the design of such a panel in terms of its objective; constitution; terms of reference and conflicts awareness and management.

Q27: Are existing sources of information regarding standards of market practice across FICC markets globally:

(a) Already sufficiently clear (or will be once current regulatory reform has concluded);
(b) Sufficient, but in need of clearer communication or education efforts; or
(c) Not sufficiently clear, requiring more specific guidance or rules to provide more detail or close genuine gaps?

The FEMR consultation highlights the challenge of trying to ensure fair and effective outcomes across global, complex and heterogeneous FICC markets. BBA members advise that the existing range of market and industry led-guidance can be contradictory, diverse (FEMR highlights no less

than seven existing codes which apply to the FX space) and often lacking in practical examples to be truly useful to front-office participants.

The BBA believes that, given these challenges, there is a very real need to bring clarity to existing market standards whilst developing more effective measures to assist user interpretation. Regulatory involvement in this process is vital so as to give markets the confidence that they are following 'best practice'. Given that the development of a new all-FICC-market-encompassing industry code would be time-consuming, difficult to draft, require frequent amendment and would unlikely in any case provide the necessary granularity required by industry, the BBA does not believe that there is any significant benefit in do so. Instead, the BBA recommends that FEMR focus on how to improve the efficacy of existing codes as they apply to individual markets, accompanied by recommendations around better education and internal monitoring.

As a first step, the BBA believes that international policy makers and industry should work together to develop globally consistent principles aimed at securing agreed outcomes. Following agreement – and in partnership with national regulators – existing codes would be reformed in line with these principles whilst addressing identified vulnerabilities or 'grey areas'. These amended codes could specify both accepted and unacceptable behaviours, and provide examples of both. Processes to quickly and clearly respond to market queries would then be developed (such as living Q&A documents), again drawing on industry-regulator cooperation.

In order to give these codes 'teeth', we believe that clear regulatory endorsement of these amended codes is required. There is no legislative provision in the *Financial Services and Markets Act 2000* specifically providing for the FCA to confirm/approve guidance issued by an industry body; however the FCA's legislative power to publish guidance in section 139A of the *Financial Services and Markets Act 2000* (as amended) is extremely broad. We are of the view that this would cover the giving of guidance about which industry codes the authorities considers 'best practice'.

Further integration of the spirit and functioning of these codes into every day market practice could be achieved through a number of means. This could include the integration of the code (or its principles) into company and board mission statements, job descriptions and company remuneration policies, with proof of continuing adherence incorporated into annual appraisals and promotion prerequisites. In addition, regular face-to-face training courses should be made mandatory. These steps would be particularly relevant for front-office management positions, although the BBA accepts that there would need to be due regard paid to matters of employment law for these to properly work.

A significant problem with regard to codes of conduct is that market participants need to know that such codes are not simply a tool for regulators to take enforcement action but that compliance with codes of conduct provides a 'safe harbour' (for example, the structure of the Code of Market Conduct). Otherwise such codes of conduct do not increase certainty of market participants. Reduced certainty could have a deterrent effect on access to markets and participants from being involved in markets due to uncertainty as to how the regulator will apply a code. For that reason, where a firm can be shown to have adopted and is compliant with this competent authority-endorsed code, compliance with that code would serve as defence for firms if investigated over an alleged transgression. Should a firm then be subject to enforcement action, the reasonable extent to which that firm (or individual) was compliant with the code would be taken into account when considering sanctions.

Q28: Box 7 on pages 36–37 discusses a number of uncertainties over FICC market practices reported by market participants, including: the need for greater clarity over when a firm is acting in a principal or an agency capacity; reported difficulties distinguishing between legitimate trading activity and inappropriate front-running or market manipulation; and standards for internal and external communication of market activity. To the extent that there are uncertainties among participants in the different FICC markets over how they should apply existing market standards in less clear-cut situations, what are they?

Transparency and a clear understanding as to the basis of a relationship between customers and clients is critical to resolving these issues. The BBA notes that in some cases, it is not always explicit when a firm is acting as agent or in a risk taking capacity. In order to prevent such confusion, participants should agree at time of trade whether they are acting as agent or as principal.

Q29: How could any perceived need to reduce uncertainties best be addressed: (a) better education about existing standards; (b) new or more detailed market codes on practices or appropriate controls; or (c) new or more detailed regulatory requirements?

In general terms, financial markets codes of practice and other guidance on industry best practice may perform one of two roles:

- Filling gaps in areas in which formal regulatory rules either do not exist or are limited in scope. An example of this is the Non-Investment Products Code (or "NIPS Code") that applies in the foreign exchange, money and bullion markets, which fall outside the scope of the FCA handbook. In the retail banking space, this was a role previously fulfilled by The Banking Code, prior to the introduction of the FCA's Banking: Code of Business sourcebook in 2009.
- Amplifying or guiding the interpretation of rules in areas where formal regulatory rules do exist. An example of this would be the Joint Money Laundering Steering Group's Guidance on anti-money laundering; for example, paragraph 6.3 of the FCA's Senior Management Arrangements, Systems and Controls sourcebook ("SYSC") provides that "[t]he FCA, when considering whether a breach of its rules on systems and controls against money laundering has occurred, will have regard to whether a firm has followed relevant provisions in the guidance for the United Kingdom financial sector issued by the Joint Money Laundering Steering Group."

These two roles are subtly different.

- In the first role, codes may help to ensure fair and effective markets in lieu of formal regulatory rules by providing "guidance on what is currently believed to constitute good practice in [those] markets". We note the comments on page 41 of the consultation that "[o]ne of the main weaknesses of most current codes is that they lack mechanisms for ensuring compliance"; however, this is not always the case. It is correct that the NIPS Code, for example, "has no statutory underpinning except where it refers to existing legal requirements"[11] and therefore may not always leave an individual or firm at risk of sanction from a regulator. However – in some cases – non-compliance with such codes could help to evidence non-compliance with the FCA's Principles for Business ("PRIN"), as happened in the FCA's recent fines imposed on five firms[12] for manipulation of the G10 spot FX market, where both the NIPS Code and the Model Code issued by the ACI – the Financial Markets Association (the "ACI" and the "ACI Model Code" respectively) were referred to in evidencing the standards of behaviour expected in that market. In addition,

[11] Ibid.

[12] See FCA Final Notices against firms 114216, 121882, 124491, 124704 and 186958: http://www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings.

breach of codes can lead to disciplinary action from the individual's employer and non-compliance with a code may be relevant evidence in the event of civil proceedings from counterparty.

- In their second role, codes of conduct play a complementary role to formal regulatory rules that do exist; the formal rules may rely on codes to fill in additional detail and update best practice guidance from time to time without the need to amend the underlying legislation. Reliance on the codes may again carry evidential weight or may even go so far as offering safe harbours in circumstances in which firms or individuals comply with the codes, although in the absence of a statutory underpinning the codes will not have the power to do this themselves and will require some form of adoption or recognition by the formal regulatory regime in order for this to happen.

In the BBA's view, increased support of and an expansion of the role of codes could play an important role in ensuring fairer and more effective markets for counterparties in wholesale FICC markets. However, we believe the focus should not just be on the mechanisms for ensuring (or incentivising) compliance with the codes. Arguably of equal importance are:

- The content of the codes themselves and, in particular, ensuring that they are a practical, effective guide to appropriate and inappropriate behaviour that are in fact understood and applied by front office staff; and
- The extent to which front office staff are required to be literate with the codes, i.e. the extent to which those codes are embedded within organisations.

If there is a constructive criticism of some codes, it is that they have a tendency to be relatively abstract and do not always include practical examples of the sorts of behaviour that would be considered acceptable under the code. This is in fact acknowledged in the preamble to the ACI Model Code, which provides that "the contents of The Model Code are, to a certain extent, generic." There are exceptions to this; for example, the general principle in Annex 2 of the NIPS Code that "manipulative practices by banks with each other or with clients constitute unacceptable trading behaviour" is amplified by some practical examples, e.g. the guidance in paragraph 52 of the code on price flashing, spoofing and creating false liquidity, although the term "spoofing" is not itself used.

With these considerations in mind, there may be an argument that codes should include more extensive, practical guidance on how front office staff should go about meeting their contractual, fiduciary or other obligations to their counterparties and prevent damage to the wider market, with more worked examples. In tandem with this, staff should be required to familiarise themselves with and demonstrate their familiarity with the codes on an ongoing basis, in compliance with firms' obligations under the FCA's Training and Competence ("TC") sourcebook. We note that, as things stand, the use of codes is not referred to directly in chapter 2.1 of TC on assessing and maintaining competence of employees, although provisions of the codes may form part of the appropriate qualifications and necessary coaching arrangements referred to in that chapter. In addition to this, the authorities could consider whether more widespread adoption and recognition of codes within the formal regulatory regime could better incentivise compliance, e.g. by including more frequent safe harbours and/or evidential provisions relating to reliance on the codes as under SYSC 6.3. This may assist in ensuring that codes act as a genuine kite mark of best practice, rather than an informal document sitting outside the formal regulatory regime.

There is clearly a need to close the gap between existing codes and formal regulatory rules, for example by providing a mechanism through which industry-wide codes can be endorsed and firms' arrangements for ensuring compliance with those codes can be certified, whether directly or through practitioner panels. For more information on how the BBA believes this is best achieved, please see question 27.

Q30: How can the industry, firms and regulators improve the understanding of existing codes and regulations by FICC market participants and their managers?

Please see our answers to questions 27 and 29.

Q31: Should there be professional qualifications for individuals operating in FICC markets? Are there lessons to learn from other jurisdictions — for example, the Financial Industry Regulatory Authority's General Securities Representative (or 'Series 7') exam?

The BBA notes that notwithstanding the lack of a mandated 'licence to trade' qualification, many market firms already require their employees to attain various professional qualifications before trading, with some examples being those offered by the Chartered Institute of Securities and Investment or the Chartered Alternative Investment Analyst Association. This is certainly the case in most banks, and is often in addition to the FCA-mandated authorisations individuals must hold (such as the CF30) as part of their role.

Whilst we do not believe that a 'licence to trade' requirement will by itself guarantee fair and effective markets, the BBA believes that in order to promote the highest possible standards in wholesale FICC markets, a requirement for all FICC market participants – regardless of the regulatory status of their employer – to hold a qualification should be introduced, subject to conditions. First, UK authorities must not create or stipulate a new single certification unilaterally – instead, any list of accepted qualifications must be developed in partnership with industry to identify those industry administered qualifications that could satisfy the need for a 'licence to trade'. Second, a well-developed and comprehensive equivalence regime recognising third country qualifications is a vital prerequisite; it must not serve as an impediment to importing key talent in any way but should assist employers to make assessments of a potential employee's competence.

The FEMR consultation refers to the Series 7 exam and the Dutch Banking Code. In regard to the latter, while this might be the right approach in a Dutch context, the UK has chosen a different route by proposing a regulatory regime which will enhance individual responsibility and reform banking governance (see question 35 for more detail). In regards to the former, the BBA notes that the Series 7 exam is administered by the Financial Industry Regulatory Authority (FINRA), a non-governmental organisation underpinned by a very different statutory basis from that in the UK. As an independent, not-for-profit organization authorised by Congress, FINRA – and other US organisations like it, such as the National Futures Association – protect investors by making sure the securities industry operates fairly and honestly through its power to create rules, measure compliance with those rules, issue fines in cases of non-compliance and administer licensing exams. In the UK, these powers (where applicable) are administered solely by government entities such as the FCA.

Q32: What role can market codes of practice play in establishing, or reinforcing existing, standards of acceptable market conduct across international FICC markets?

Please see our answers to questions 27 and 29.

Q33: How would any code tackle the design issues discussed in Section 5.4.3, i.e.: how to ensure it can be made sustainable given industry innovation over time? How to differentiate it from existing codes? How to give it teeth (in particular through endorsement by regulatory authorities or an international standard setting body)? How to communicate it to trading teams? Whether, and how, to customise it for individual asset classes?

In addition to points made in answers to questions 27 and 29, the BBA highlights that under the proposed Senior Managers and Certification regimes there will no longer be any requirement for significant numbers of individuals across the sector to be pre-approved on the strength of high quality and extensive information held by the FCA. Under the new regime, firms will be required to self-certify an individual's fitness and propriety. We support this approach.

We are concerned that the discontinuation of the FCA register could have a negative effect on the ability of firms to assess a potential employee's fitness and properness before they are hired. Although firms will be able to request references from other firms, the information is likely to be more limited than is currently available. Furthermore, the absence of a requirement on firms to send deregistration filings to the FCA explaining the reasons for an employee's departure means that important information on individuals will no longer exist. Industry needs the help of the regulators, as the regulators can retain information that a prospective employer does not have access to; the proposed rules make no provision for the continuation of valuable conduct history records, which we believe should be maintained.

Q34: In the context of implementing MiFID 2, which of the FCA Principles for Businesses should apply in relation to MiFID business with Eligible Counterparties?

We note with that notwithstanding the enhanced duties owed to Eligible Counterparties coming under MiFID II and the increased expectation that between sophisticated professional counterparties there are expected standards of market practice and conduct, expansion of the Principles should not be interpreted as requiring such counterparties to treat each other with the same trading duties as if they were trading with retail or professional counterparties.

Q35: Are there any financial instruments that should be brought more fully into the scope of regulation in order to improve the fairness and effectiveness of specific FICC markets? For any instruments proposed:

(a) what protections does the current framework provide;
(b) what gaps remain of relevance to fairness and effectiveness; and
(c) what is the cost/benefit case, bearing in mind the Review's Terms of Reference as set out in Section 1?

It is not strictly correct to say that recent incidents of market misconduct have occurred in a completely unregulated space, for in many instances those engaging in misconduct were acting contrary to established industry guidance, FCA principles or UK legislation, and almost certainly not in the best interests of their firm. Indeed, recent cases of FICC market misconduct have arisen largely due to conduct failings by market participants rather than problems relating to an instrument's regulatory coverage. Accordingly, we believe that policy makers should focus on measures that address conduct vulnerabilities as they apply to wholesale FICC market participants. Given the global nature of wholesale FICC markets however, uncoordinated efforts to regulate specific instruments would become self-defeating with trading liable to be moved elsewhere.

FEMR rightly identifies failure of governance as a key source of vulnerability. In this regard, the banking sector has been and continues to be subject to considerable reform through such means as:

- New criminal sanction of reckless misconduct in the management of a bank;
- Reversal of the burden of proof in civil misconduct cases;
- Senior Managers Regime (SMR);

- Certification Regime; and
- Changes to Rules of Conduct.

When considering matters of scope, it is appropriate to consider recent banking governance reforms in the UK. The BBA is supportive of the SMR and believes it forms a critical component of the UK's governance framework. Nevertheless, there are a number of issues which remain deeply problematic and should be addressed. These can be summarised as:

- The inclusion of the non-executive directors within the scope of the SMR regime;
- The application of the reverse burden of proof;
- The unduly wide scope of certification requirements (as applied by the FCA);
- The implementation timeline;
- Continuance of the FCA register in order to assist in assessing 'fitness and properness';
- The potential extra-territorial application; and
- The SMR's duplication with authorised person's regime[13].

Whilst banks are systemically important institutions undertaking important economic tasks such as credit intermediation and maturity transformation in FICC markets, they are by no means the only institutions vulnerable to conduct failings. Furthermore, the failure of a large non-bank institution would likely induce significant market disruption and uncertainty. Accordingly – subject to the regime being reformed to address the above issues – the BBA recommends that all relevant employees of all non-bank firms operating in wholesale FICC markets should be subject to either the senior manager or certification requirements as described in FCA CP14/13. This will help ensure that markets remain fair, effective and a level playing field for all.

As a reference, the augmented principles applying to Senior Managers:

SM1: You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.

SM2: You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant requirements and standards of the regulatory system.

SM3: You must take reasonable steps to ensure that any delegation of responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.

SM4: You must disclose any information of which the FCA or PRA would reasonably expect notice.

The implementation challenges associated with this expansion may be less for smaller firms than for larger ones. This is because smaller firms are likely to undertake a smaller range of FCA key functions (which will require allocation of a senior manager), have fewer employees who are material risk takers or otherwise subject to the Certification Regime and have fewer employees in total to whom the Rules of Conduct apply. Offsetting this are the compact compliance teams in smaller firms who will have to deal with the on-boarding of new senior managers and the requirement to amend appraisals and job descriptions to enable evidencing of 'fitness and properness'.

[13] For more information on these issues and they can be reformed, please see https://www.bba.org.uk/policy/financial-and-risk-policy/hr/strengthening-individual-accountability/strengthening-accountability-in-banking/

Q36: How much of a role did inadequate governance, accountability and incentive arrangements play in the recent FICC market abuses, and to what extent do these remain potential vulnerabilities in FICC markets globally? In addition to on-going regulatory changes, what further steps can firms take to embed good conduct standards in their internal processes and governance frameworks? And how can the authorities, either internationally or domestically, help to reinforce that process, whether through articulating or incentivising good practice, or through further regulatory steps?

The BBA is not in a position to comment as to the detail of recent cases of FICC market abuses, but in general we do believe that inadequacies in governance, accountability and incentive arrangements contributed. Significant reform has been undertaken to address these vulnerabilities both through regulation and market-led action. Nonetheless, these abuses were completely inappropriate, contrary to the principles of fair and effective markets and completely repudiated by the vast majority of market participants.

As outlined in question 35, there have a number of significant regulatory proposals which will to improve banking governance including the:

- New criminal sanction of reckless misconduct in the management of a bank;
- Reversal of the burden of proof in civil misconduct cases;
- Senior Managers' Regime and Certification Regime;
- Changes to Rules of Conduct; and
- Changes to remuneration policies as a result of EU legislation[14] that introduces longer deferral period and a greater proportion of variable remuneration paid in equity, so as to incentivise long-term performance and align risk and reward.

Many of these reforms have been only recently introduced or are not yet been fully developed so should be given time to bed-in. Where authorities can help is by working flexibly, openly and transparently with industry in implementing and assessing these initiatives over time. In terms of supervision, the BBA supports calls for regulators to focus their resources on incidents of deliberate (and potentially criminal) wrongdoing. Negligent or accidental breaches are best dealt with by requests for procedural change, warnings or requirements for training. Finally, the BBA believes that the FCA should be more discriminating when considering whether misconduct is largely due to an individual's actions, rather than a failure by a firm's systems and controls. This will encourage more open and effective engagement by firms of all types.

Non-regulatory steps to embed good practices within firms start with placing the board at the centre of good culture. Boards that embrace compliance principles, practice strong oversight, exhibit intellectual curiosity and take responsibility for their firm's operations are the most effective tool to securing positive outcomes. Necessary tools to achieve these goals include the greater use of non-quantitative metrics such as internal surveys and training reports as well as encouraging and rewarding full and frank disclosures by senior management and supporting whistle-blowing.

Middle and front-office management has a vital role in not only facilitating these values throughout a firm, but also identifying and addressing conduct or structural vulnerabilities as they arise. Tools which can work at this level include regular and mandatory face-to-face training (both internal and external), incorporating conduct requirements into job descriptions, remuneration appraisals, and promotion requisites. In the case of the banking sector, this could be linked to the requirements of the Senior Managers Regime.

[14] CRR and CRD IV specifically.

Q37: Do respondents' agree that the thematic areas highlighted in Section 5.5 are key priorities for FICC firms (fine-tuning performance measures; adjustments to remuneration; attitudes towards hiring, promotion and advancement; closer board involvement in governance of FICC activities; and clearer front line responsibilities)? What specific solutions to these challenges have worked well, or could work well? And how best can the authorities help to support these initiatives?

We agree that these themes are important, with the banking sector dedicating significant resources to addressing identified shortcomings in these areas. The experience of BBA members in this regard can inform FEMR as it develops its recommendations. Examples which could be drawn on include:

- Changing the metrics used to assess an individual's performance so as to include areas such as conduct risk rather than purely financial measures. BBA members report that this has helped ensure that firms, managers and individuals are reviewing the business performance through a conduct lens as well in terms of profitability.
- Instigating a formal consequence management process that tracks any behaviour not in line with expectations. There is an expectation that this will have an impact in terms of both rating and remuneration for staff who do not meet the standards;
- Incorporating conduct requirements into promotion assessments, with individuals who have not met the minimum standard not being eligible for promotion; and

In addition to applying the provisions of the senior managers regime to other FICC-market stakeholders, BBA members believe that the ability to claw back remuneration from FICC market participants, where conduct and management risks has resulted in systemically negative outcomes, is an important principle.

Q38: To what extent could the Banking Standards Review Council (BSRC) help FICC market participants to raise standards collectively — in particular, are there other steps that could be taken to help complement or extend this initiative in FICC markets for non-banks and internationally?

Given the global and heterogeneous nature of wholesale FICC markets, policy makers should consult extensively with market participants and foreign jurisdictions as to what entity could be utilised to bring drive any global reform efforts. This entity must be sufficiently global in scope and must consist of both regulators and industry in order to be effective, with the latter group comprising a broad range of market participants. Such an entity should be empowered to identify 'grey areas' requiring action, make recommendations as to how best address these vulnerabilities, and promote and assess global coordination. There may be a role for the BSRC insofar as the London markets are concerned once further information as to its mandate, scope and governance arrangements becomes clear.

Q39: Are there other regulatory measures the authorities could take to strengthen personal accountability or otherwise improve the way firms manage incentives and governance? In particular, should any or all of the measures in the Senior Managers and Certification Regime be extended to non-bank firms active in FICC markets?

Please refer to questions 36 and 37.

Q40: What role can more effective surveillance and penalties for wrongdoing play in improving the fairness and effectiveness of FICC markets globally? How can firms and the industry as a whole step up their efforts in this area? And are there areas where regulatory supervision, surveillance or

enforcement in FICC markets could be further strengthened?

Penalties are important regulatory tools to change behaviour not only in a punitive sense, but also through clearly signalling to the market (and public) that a gross transgression has occurred. Nevertheless, penalties also represent a failure by individuals, firms and regulators to detect and address a failing or vulnerability at an earlier stage, potentially limiting the damage not only to the firm, but also to other affected stakeholders and the market. It should be noted that monetary penalties are a last resort when trying to effect change as they are a blunt tool that does not guarantee the original transgression has been remedied. For further commentary on penalties please see question 36.

Proportionality is an important principle, and here the BBA notes the FCA's policy framework regarding sanctions and penalties.

Q41: How can firms increase the effectiveness of their own surveillance efforts across FICC markets globally? What role could the industry play in helping to explore best practices on how to make whistleblowing and other similar regimes more effective? Is there scope to make greater use of large scale market data sets and electronic voice surveillance to help detect cases of abuse in FICC markets? Are there other potentially effective tools?

BBA members have advised that increasing the number of staff employed in control function or compliance monitoring can increase the effectiveness of surveillance efforts, although that is by no means guaranteed. Technology can offer solutions through the use of automated trade surveillance tools and pattern analysis across key metrics, or through the active monitoring of staff emails, calls and chat rooms activity. Ultimately there is no single tool which can offer a totally comprehensive solution. Firms need to apply a range of methods depending on the circumstances.

Q42: Are there processes or structures that can allow firms to punish malpractice by their own staff more effectively (for example, penalties for breaching internal guidelines)?

BBA members have advised that current industry practices are effective.

Q43: Could firms active in FICC markets do more to punish malpractice by other firms, for example by shifting business and reporting such behaviour to the authorities?

The BBA believes that market discipline combined with the ability to remedy contractual violations through court proceeding offer (i.e. the launch of court action) offers firms sufficient remedy to punish wrong-doing.

We note that suspicious transaction reporting already exists and is being strengthened by the provisions in MiFID II.

Regulatory level surveillance and supervision

Q46: What further steps could regulators take to enhance the impact of enforcement action in FICC markets?

In terms of supervision, the BBA supports calls for regulators to focus their resources on incidents of deliberate (and potentially criminal) wrongdoing. Negligent or accidental breaches are best be dealt with by requests for procedural change, warnings or requirements for training. Finally, the BBA believes that the FCA should be more discerning when considering whether misconduct is by

individuals, as opposed to a failure by a firm's systems and controls. This will encourage more open and effective engagement by firms of all types.

Q48: Is there a need to widen and or strengthen criminal sanctions for misconduct in FICC markets?

The introduction of a Europe-wide CSMAD has done much to harmonise rules in Europe and we would also welcome greater harmonisation on a global level. We also believe that firms that fail to put adequate anti-market abuse systems and controls in place and thereby allow market abuse to occur should be liable to tough penalties. Such penalties play a very important role in ensuring that market participants invest in robust anti-market abuse systems and controls.

In this context, as the UK government considers whether the UK rulebook approach needs to be modified, inter alia given the adoption of CSMAD, the BBA make a general point that we believe that in the criminal space in the UK there already exists sufficient criminal sanctions to cover most, if not all, of the areas of market abuse subject to investigation over the last few years. These should be used - we do not see the need for new criminal sanctions relating to CSMAD or generally.

Q49: Is the approach set out in the Criminal Sanctions Market Abuse Directive appropriate for the United Kingdom? Are there additional instruments or activities to those envisaged by the Directive that should be covered by the domestic criminal regime?

Whilst the BBA generally supports the approach taken in CSMAD, we note that Articles 7 and 8 of CSMAD pose some issues that should be addressed if the UK seeks to implement a similar regime. In summary, Articles 7 and 8 require EU Member States to make a legal person liable to "criminal or non-criminal" fines or other serious sanctions where criminal market abuse is committed for its benefit and (a) the offender held a "leading position" within the legal person or (b) the offence was made possible by a lack of supervision or control by such a person. Article 7 provides that a person will be treated as having a "leading position" based on a power of representation, authority to take decisions or authority to exercise control.

The policy purpose of Articles 7 and 8, given by the European Commission, is that it is appropriate to fine a firm where a market abuse offence has been committed for its benefit and that the imposition of a penalty "could … encourage financial institutions to take the organisational measures and provide the staff training necessary to prevent violations".

The current UK enforcement regime already enables regulators to impose penalties on firms that fail to prevent and detect market abuse. We believe the current UK enforcement regime is robust and provides a credible deterrent against firms failing adequately to invest in anti-market abuse systems.

Therefore, whilst we fully support the policy objective intended by Articles 7 and 8 (as important principles already enshrined in the UK current enforcement regime and principles that should be enshrined), we have two principal concerns.

First, we are concerned that in implementing a UK regime, Articles 7 and 8 do not provide an incentive for firms to invest in such systems. Instead they expose firms to the risk of potential criminal liability and other serious sanctions where market abuse is committed for their benefit by a 'leading person'. The consequences of such criminal liability can affect international firms' operations globally (in some jurisdictions, for example, a finding of corporate criminal liability can lead to debarment from government contracts). Many jurisdictions that make corporates criminally liable for acts committed

by their officers/or employees have put in place mitigants, such as 'adequate procedures' based defences. However, under CSMAD there are no such mitigants on the face of the text. A firm at which market abuse is committed by a person with a 'leading position' may be liable under Article 7 (1), even if the firm can demonstrate it had robust anti-market abuse systems and controls in place when the market abuse was committed. This appears to run counter to the stated policy purpose of Articles 7 and 8.

Second, we are concerned that the scope of Articles 7 and 8 is unclear. It is presumably intended that only the senior management of a firm (such as directors or de facto directors) will be treated as holding a 'leading position'. However, Article 7 could be misread as treating more junior employees as holding such a position given that (for example) a trader will typically have authority to make certain representations and enter into trades on behalf of a firm. While it is clearly right that any individual (however junior) who engages in criminal market abuse is personally subject to criminal sanctions, we believe it is important for the purposes of establishing corporate liability that the definition of 'leading position' is clear.

In the light of these concerns we believe that, as the Government decides how best to modify the current UK criminal market abuse regime, it should consider the importance of any resulting legislation:

- Making clear that a legal person will not be held liable for the Article 7 like offences if the legal person can demonstrate that, when the relevant market abuse offence was committed, it had adequate systems and controls designed to ensure that persons acting for its benefit did not engage in market abuse. This is consistent with the approach adopted by the UK to corporate liability for bribery in section 7 of the Bribery Act 2010 and is in line with achieving the stated policy purpose of Articles 7 and 8.
- Imposing criminal liability for the Article 7 offences in accordance with the English common law 'controlling mind and will' test.
- Clarity that an individual is only treated as holding a 'leading position' within a legal person if the individual manages or directs the legal person, or a significant business unit of the legal person.

We would particularly like to underline the importance of maintaining a clear demarcation of responsibility for the oversight of firms' anti-market abuse systems and controls between regulatory authorities in different EU Member States.