The Fair and Effective Markets Review

Lloyds Banking Group (Lloyds) welcomes the opportunity to provide input to the joint exercise by HM Treasury, Bank of England and the Financial Conduct Authority ('the Reviewers') to examine the FICC markets. The output of this exercise will be helpful in informing the Government's and Authorities' engagement in international and EU forums as they seek to proactively influence supervisory developments and public policy approaches to deliver good outcomes for users and restore public trust in the fixed income, foreign exchange and commodities (FICC) markets.

Our response commences with some key high level observations about the regulatory framework and nature of the FICC markets, followed by more detailed remarks in relation to areas which are of particular interest to Lloyds. We have organised our more detailed remarks by theme, these are:

1. Market Code of Conduct and Qualifications
2. Structural Change and the Impact on Market Effectiveness
3. Price Transparency
4. Clarity on whether Firms are Acting as Principal or Agent

We would welcome the opportunity to discuss our response with the Reviewers in more detail. We also look forward to further opportunities for engagement with the Reviewers as their consideration of wholesale markets more broadly continues. We will be particularly interested to learn how the outcome of the Review informs contributions to IOSCO and to the EU Commission's Capital Markets Union initiative.

Observations

- We welcome the acknowledgement in the consultation paper that the FICC markets are global in nature. Any unilateral changes which the UK seeks to make in these markets will be challenging. In the absence of competing EU legislation it would be possible to impose new regulatory requirements on UK firms, but, in reality, change would need to be driven at a global level through the International Organization of Securities Commissions (IOSCO), or at a regional level through the EU.
- It is important that any recommendations HMT, the Bank of England and the FCA ('the Reviewers') make preserve both the UK's and, by virtue of London's position as the EU's major financial centre for the EU, the EU's global competitiveness. This may mean that the scope for unilateral change is limited initially, but it should ensure that the UK is on a firm footing to lead market supervisory development at a global level.
- We support the development of guidance by the industry to drive up standards and we would encourage an element of flexibility of application across different business models. The industry

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has been, and continues to be, subject to a high volume of regulatory change and higher standards of market conduct; we are supportive of these changes being implemented and embedded.

- We note that the consultation paper instructed readers to take the post-crisis prudential package of reforms as 'a given'. While we appreciate the drivers of this position, it is appropriate to highlight, as a general point, that there is significant interconnectedness between conduct and prudential regulation. It is possible that, as the discussion matures, there emerge some solutions which the Reviewers may consider not feasible without changes to elements of the prudential reform package. It is therefore very helpful that the Bank of England, as the UK's representative organisation to the Basel Committee, is among the Reviewers and can bring its expertise and influence to bear at this critical international standard setting forum.

Detailed Remarks

1. MARKET CODE OF CONDUCT AND QUALIFICATIONS

Currently the industry has a number of conventions, practices and processes that can be open to interpretation. While we recognise that it would be impossible to codify all aspects of acceptable behaviour, an improved Market Code of Conduct should be set at a level of enough detail to reduce uncertainty. This could be achieved by providing a clear statement of expected client outcomes as the basis for the code. Such a Code could be provided by an industry body, endorsed by the Regulator as confirmed industry guidance and reviewed on a regular basis. A Market Code would also provide an opportunity to develop norms of conduct around acceptable (and unacceptable) interactions with brokers and counterparties regarding market developments or 'colour,' taking account the specificities of different types of market and typical scenarios. It would then be up to each market participant to apply the code to its own business model supported by a clear set of internal procedures and guidance on behaviour that is and isn't acceptable in particular circumstances.

It would be reasonable to expect that for those who abide by the Market Code of Conduct and its principles there is a degree of leniency or protection from the regulator. Similarly, the regulator should be able to hold individuals who do not abide by the code, to account.

In our opinion, a common minimum standard of market knowledge and education across the industry should be a goal of a sophisticated market (Ref Q39 and Q31). We believe this could work in conjunction with the initiative to strengthen accountability in banking where each firm has the opportunity to provide corporate specific training for any internal certification, supported by a common level of market knowledge. An example of this is the FINRA model in the US that is also tailored to the specific needs of different roles. Such a regime should, in our opinion, apply not only to Banks but also to non-bank firms operating within the FICC markets, such as investment firms, corporate treasuries (who are highly sophisticated participants in some key markets) and corporate advisors, with an accredited body in the centre administering the scheme.

We are supportive of mandatory professional qualifications for individuals operating in the FICC markets and we view the FINRA Series 7 exam as a good example of such a regime. We support the

concept of a 'licence to trade' for individuals (Ref Q31). This should be based around education and testing and should be market wide.

In general, it is our view that markets can best be improved through increased education and improved conduct monitoring.

2. STRUCTURAL CHANGE AND THE IMPACT ON MARKET EFFECTIVENESS

We note the Reviewers' position that there are areas where fairness and effectiveness could be improved. However, as the Reviewers acknowledge, there are a number of regulatory changes which are progressing to implementation including revisions to the EU Markets in Financial Instruments legislation (MiFID 2) and the implementing measures of the European Markets Infrastructure Regulation (EMIR) etc. There is also a range of legislative and regulatory developments arising from other jurisdictions, notably the US, which does, or may, overlap with incoming EU legislation.

It is fair to comment that the FICC markets are of a more complex nature than the equities markets, which is underscored by the distinct regulatory treatment which has been applied in legislation such as MiFID 2. It is also fair to comment that the regulatory framework that is being constructed around these markets is complex.

At this stage in the construction of that regulatory framework, attempts to introduce additional requirements could create serious unintended consequences which could have a significant impact on the wider economy. That the markets concerned are global in nature further poses the risk that any unilateral change introduced by the UK authorities could have consequences for the UK's global competitiveness and, by virtue of London being a major financial centre for the EU, for the EU's competitiveness.

We take the view that a reasonable solution, certainly at this stage in the development of reforms, lies in further reinforcing the importance of Principle 3 and its underpinning regulations (e.g. the requirements set out in Senior Management Arrangements, Systems and Controls (SYSC)) to emphasise the FCA's expectations that firms employ appropriately sophisticated, robust, effective internal controls. The regulators could make greater use of the tools and applications already in hand to oversee the market. It would also be useful for the authorities to develop further regulatory guidance regarding compliance approaches and standards, to promulgate emerging best practice requirements across the industry.

The Review asks whether the current market micro-structure enhances or diminishes fairness and effectiveness and whether further steps are needed (Ref Q4). As a general principle, market structures will evolve in response to innovation and user needs. Structures will shape to meet regulatory requirements, however, organic development in response to user needs and behaviours is more likely to deliver optimum outcomes for those users.

The Reviewers should be cautious of recommending 'one size fits all' changes which can stifle such development and result in sub-optimal outcomes for users.

There are potential unintended consequences of structural change with respect to recommendations for the standardisation of Corporate Bonds (Ref Q 6). While some large, regular issuers may indeed benefit from the implementation of standardised products (possibly through more visible pricing curves) there is a real risk that less frequent and often smaller issuers may struggle to match maturities and coupon structures with their specific cash flow requirements. A 'one size fits all' model would not work for all issuers.

Any potential standardisation must be weighed against a reduction in flexibility available to companies to fund themselves and the subsequent impact this may have on the UK economy.

The Reviewers express concern that last look practices could be used to gain information on the intentions of clients without actually committing to trade. Last look practices developed to help reduce volatility and sudden market movements. If market makers were required to stream public prices without any last–look protection, they would need to significantly widen their prices.

Firms' committed adherence to Principle 3 and SYSC-related policies and procedures should mitigate against the inappropriate use of last look practices.

We would caution against introducing structural changes where the unintended impact may be to reduce the fairness and effectiveness of markets (Ref Q11). It is true that there are some markets which lend themselves to an order-based agency model but, in the FICC markets, such models are the exception and there is therefore a need for an infrastructure which supports risk-taking and market makers. Without this infrastructure, markets will become less effective – prices will widen and, in some cases, end users will be unable to access liquidity. Various regulatory changes have already reduced ability of firms to act as a liquidity provider in some markets.

A key aspect of the markets, which must be protected, is the ability of risk taking entities to act as market makers.

3. PRICE TRANSPARENCY

We are supportive of the desire to increase transparency and agree that this should form part of the definition of 'fairness'. Transparency should mean that all market participants have sufficient access to information to be able to verify that they are achieving an optimal outcome to meet their needs. For many parts of the FICC markets, to provide full public disclosure would have a negative impact on the first aspect of the effectiveness requirement, since it could reduce ability of market participants to trade at competitive prices. The Reviewers will be familiar with the discussions at EU level over pre-trade transparency under MiFID 2 and will appreciate the nuances these debates have highlighted.

To the extent possible under the framework legislation, the pre-trade transparency requirements proposed under MIFID 2 should be introduced in only the most liquid markets. In all other cases, transparency is best achieved through provision of clear communication from firms to clients.

Issuers value stable ownership and pricing in the secondary market. Any fixed scaling regulations or auctions create an increased opportunity for investors to game these benefits away to the detriment of the issuer. On the subject of transparency of allocations, there is an opportunity to go further than

just geography and investor type, however the publication of individual allocations is not the answer. One suggestion would be to disclose a table of percentages and the proportion of initial bids received (e.g., bidders in £10-15m range / received on average 65% of bid).

Lloyds is of the view that there needs to be an element of flexibility in any allocation policy. It is only through this flexibility that the interests of the Issuer can be protected against practices, such as order inflation (Ref Q7).

Structural changes such as pre-trade transparency and mandatory execution on trading venues under MIFID2 can improve price transparency, but this can only be done safely for liquid instruments (Ref Q4). In other cases, and where non-professional clients are involved, it is vital that market makers and agents demonstrate to clients that they are fulfilling the duty of best execution. The recent FCA Thematic review on Best Execution deals with this issue and makes clear that, even in markets where firms and clients are interacting on a Request for Quote rather than on an order basis, there can be a requirement to ensure best execution.

We fully support rules on Best Execution and believe that enforcing this behaviour will provide the necessary transparency for fair and effective markets.

FICC markets are already electronic in many areas, particularly for liquid products, but there is still room for expansion (Ref Q5). However, it is important not to confuse increased electronic trading with increased transparency.

It is possible to have increased electronic trading in illiquid products but that does not necessarily mean a move to order book trading is possible or that market wide transparency is advisable.

4. CLARITY ON WHETHER FIRMS ARE ACTING AS PRINCIPAL OR AGENT

There are existing clear definitions of agent and principal [Ref Q28]. Within the definition of principal, there are two sub-categories: riskless principal and risk-taking principal. Currently, FICC markets mainly operate on a principal basis and there may be lack of clarity surrounding the placing of orders where a dealer is operating as a riskless principal.

In order for clients to understand the price being passed to them, it should be clear whether dealers are providing a service on an RFQ basis or an order basis. When services are provided on an order basis the charge for that service should be clear.

Specifically:

- Fix orders are generally executed on a risk-taking principal basis whereby the risk and costs of executing the order are assumed by the firms. In order for this to be a profitable service, firms will try to hedge the position at a level better than the fix. This has clearly led to conflicts of interest across the market place in the past (Ref Q12).
- A possible solution for fix orders is the increased use of market netting facilities which are starting to develop – dealers enter fix orders into an order book and these buy and sell orders are then automatically matched at the fix price. Lloyds uses and is supportive of this approach. However, with current market practices, this is not a commercially sustainable product in the long term. If customers are netted against each other, there is no profit for the firm to cover the cost of processing the two orders. So it seems likely that firms need to start

charging a fee for execution of fix orders, or clients go directly to a netting facility (which will also need to charge a fee). However, even in these cases, it cannot be assumed that clients are being provided a service on an riskless principal basis – the mismatch of buyers and sellers in a netting facility mean that some orders will not be matched, putting the onus back on the firms to provide a risk-taking principal service for the balance.

- The issue is not restricted to fix orders as it also occurs in the general treatment of limit and stop-loss orders. In liquid FICC markets, it is normal for clients to ask for a price and then execute on that price. In this case, there is no doubt that the market maker is acting as a risk-taking principal and that any profit is included in the price being quoted. However, when a client asks to buy 'at best' or via a limit order, it is important that dealers are explicit on their pricing policy and in this situation, firms are acting as a riskless principal, executing in the market and then passing the executed price to the client. In this model, there is no opportunity for the firm to cover the costs of execution and, today at least, the FICC market is not generally a fee-charging business.
- Historically, the only way firms can directly benefit from such orders is by executing in the market at a different rate from the one provided to the client. Similarly, for limit orders, price improvements may not be passed on or, even worse, the customer order does not get filled. In order to ensure a fair outcome for clients, dealers' Best Execution Policies need to be clear on how clients are being charged and how this is communicated to them. Furthermore, where acting as a riskless principal, it could be argued that risk takers in the firm have no reason to see client orders as the order could be passed directly to the market for execution against the best price. However, in return for this order execution service, firms should be able to charge a fee, which should be transparent to clients.

This fee-based execution method of working is suitable for liquid markets. There are however illiquid markets where such an approach may also be appropriate at certain times. For example, the corporate bond market has lost much of its liquidity in the past few years as firms' ability to provide two-way market-making has been reduced. This leads to the situation where the customer and firm could agree that it may be more effective to work an order rather than transact on a risk-taking basis. In an illiquid market this may take hours, days or weeks. As with liquid markets, matching a buyer and seller at the same price is not a profitable business for firms and therefore a fee needs to be charged for this to be a commercially viable service.

The provision of a client-matching model should not be confused with a requirement to execute via trading venue or to provide absolute trade transparency to the market. As discussed earlier, these models are not suitable for illiquid markets. None of the above analysis implies a need for new regulations. The recent FCA Thematic Review on Best Execution clarifies the requirement to explain costs and charges to clients.