January 2015

Submission by the International Regulatory Strategy Group

to the Fair and Effective Markets Review

Dear Minouche

This letter is written in response to the Fair and Effective Markets Review Consultation of October 2014 and is submitted on behalf of the International Regulatory Strategy Group (IRSG). The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to be one of the leading cross-sectoral groups in Europe for the financial and related professional services industries to discuss and act upon regulatory developments.

Within an overall goal of sustainable economic growth, it seeks to identify opportunities for engagement with governments, regulators and European and international institutions to promote an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views.

It is an advisory body both to the City of London Corporation and to TheCityUK.

The submission's key points are that the impact of any proposals for further regulation needs to be fully assessed; that market participants need to engage in collective action endorsed by the regulators; and that, given the global nature of the wholesale markets, the UK should only act in isolation if there are wholly compelling reasons.

Introduction

The IRSG warmly welcomes the initiative to establish this Review. UK market participants, both users and providers of financial market services, need to be able to rely on Fixed Income, Currency and Commodity (FICC) markets, both within and outside the UK, whose integrity is unquestionable and from which recently uncovered abuses are absent. Events have cast doubt on the integrity of some markets and it is of the utmost importance that their integrity be re-established as soon as possible.

The Review covers a very wide range of markets and involves a wide range of players, both in the UK and globally. This submission does not attempt to reflect the very wide range of interest of the many parties involved, some of which will in their very nature be conflicting, as is the essence of markets. Nor does it seek to provide an in-depth technical response, where a number of trade associations and practitioner firms are already inputting to the consultation.

Instead it focusses on overarching issues which are referred to in the Consultation paper, but which are not explored in any depth. The issues are referred to in paras 13 and 14 of Section 1.4 of the Consultation which refers to the principles guiding the review's work.

The first relates to the recommendations needing to "have due regard to the impact on the efficiency, competitiveness and growth-generating potential of the financial services sector, and the cost of regulatory resources." Related to this is the way in which the market itself can improve standards of behaviour beyond the scope of direct regulation.

The second relates to the Review's "recognition that the FICC markets are global in scope, and shaped by forces far wider than those in the United Kingdom alone" and "are likely to require global discussion".

Impact

As the Consultation points out, FICC markets underpin almost every major financial transaction in the global economy, which means they have a direct impact on millions of end users, both individuals and corporates. This means that it is very difficult, indeed verging on the impossible, to identify and quantify the ultimate consequences of particular market developments. This is also true of the consequences of abuses. As the Consultation notes (page1), abuses "fundamentally undermine the primary function of markets to provide price signals to the broader economy and allocate resources effectively-and they materially increase uncertainty…" It is in principle possible to form estimates (no more) of the immediate consequences for market rates of particular abuses, but it is much more difficult to establish their ultimate incidence, particularly on final users, not least because in every market there will be buyers and sellers who will experience contrary consequences.

The consequence of this is that it will also be difficult to measure the potential consequences of the implementation of any recommendations for reform. However, before discussing further the issue of the impact of potential new regulatory measures, it is worth observing that an overriding test must be the extent to which any measure serves to restore confidence and market integrity.

Regulatory Response

Given the huge volume of regulatory reforms that have already been introduced in the last five years, some of which, including those relating to remuneration incentives, the roles of boards and the responsibilities of senior managers, will have a direct impact on FICC markets, the IRSG believes it important for these reforms to be given time for the impact of their introduction to be assessed. It is likely that some of these regulatory reforms will address some of the issues being considered by the FEMR and therefore additional regulatory proposals should only be considered if absolutely necessary.

This does not, of course, mean that recommendations should not be implemented where there is evidence that they will make markets either fairer or more effective, but it does mean that such evidence has to be very robust and reliable.

This means that application of the principles of good regulation is as critical here as anywhere. The recent track record of the application of impact assessments in financial regulation is not very encouraging, particularly in adopting responses to the recent crisis. This is not just because the application of impact assessments is intrinsically difficult, which it is, but also because there can be political pressure to be seen to be taking action even where it may be ineffective, costly or counterproductive.

In relation to whatever proposals for direct regulation may emerge from FEMR (which this note does not seek to address in substance), it is still vital as an overarching matter to recall some of the critical tests of better regulation. These tests are relevant both in relation to regulatory or market reforms at the national level and at the global level.

In relation to any proposed new regulatory action the proposal should:

1. **Identify the mischief precisely and what the planned remedy is intended to achieve.** Without complete prior understanding of what perceived problem a new rule is supposed to address, it is not possible to know what character of rule to adopt or how much detail the rules need to provide.
2. **Identify the precise market a new rule is intended to affect**. Changing a market structure, whether national, European or global, without good reason could be a costly exercise without necessarily corresponding benefits for both the immediate and the final customers in those markets.
3. **Choose the right policy tool**. At one level this involves deciding which tool is best to address the mischief; whether an issue is best addressed by enhancements to competition policy, by supervisory activity or by enforcement. At another, it means deciding whether there should be greater detail in rules about what precisely firms should or should not do or whether the rule might better incorporate a set of considerations against which a firm's decision would be assessed by supervisors and overruled if determined to be excessively risky.
4. **Identify the right kind of rule**. Is the best approach one addressed at content, process, outcome or behaviour? Content relates to a specific requirement which must be met. Process sets out a set of actions which must be followed over time. Outcome relates to what is to be achieved, perhaps at a certain level of generality. Behaviour specifies or prohibits the way in which an act must be undertaken. There need also to be tests relating to how the rule is to be used; is it to be enforced and if so is it suitable for this purpose; is it just a means to an end rather than the outcome itself and, if so, is it likely to deliver this outcome; what are the risks of the rule generating unwanted changes in behaviour; and so on.
5. **No rule should be more detailed than necessary**. This is needed to avoid unrealistic implementation challenge, particularly in the light of the spate of recent regulatory reform, and partly to avoid diversion to rule evasion rather than true risk mitigation.
6. **Assessment of cumulative cost of changes in regulation should always be undertaken**. When impact assessment and cost benefit exercises are being conducted the individual costs associated with each piece of legislation should be examined alongside the cumulative cost of regulation as it affects a particular sector rather than simply being assessed on a stand-alone basis. This is to address the risk that individual pieces of legislation might appear cost-justified in isolation, but not if

the overall cumulative impact on the market concerned is taken into consideration. It is recognised that such cost-benefit exercises are extremely challenging, but they must be attempted.

A process to apply all of these principles to any recommendations contemplated in the FEMR would reduce the risk of damaging legislation/rules being introduced. As already mentioned above, this is all the more critical in the context of the FEMR because of the all-pervasive global reach of the FICC markets and the impact on final users.

The IRSG also believes it will be as important as ever for a dialogue to be available between regulator and regulated to discuss any uncertain areas of regulatory application and guidance.

Market Behaviour

Confidence is difficult to measure, but one aspect of achieving this will be that the industry is seen to be setting its own house in order, including addressing the behaviour of individuals. Collective action by the industry is necessary at both the national and global level. Market practitioners and organisations must take independent action to address the problems in FICC markets that have undermined confidence.

Voluntary action has already started in the UK in a number of areas and this work needs to continue. The IRSG recognises that there will be public concern about the voluntary nature of purely market-led reform and that it must deliver results that are beyond reproach. Within individual firms the right tone needs to be set by the senior management as to the standards of behaviour expected of employees and these need to be entrenched at all levels of the firm. This should be supported by other practical measures, including proper procedures for escalating concerns with behaviour, robust 'whistle-blowing' procedures, non-financial incentives regarding career development, and education and training programmes that illustrate good practice.

Market initiatives need to address both buy side and sell side in all relevant market sectors. Where possible, market codes should be amended or where necessary introduced to address the problems which have been identified. Such codes should to the extent possible encompass participants in all relevant market centres.

When and where it is clear that market codes are fit for purpose it would be highly desirable that they are given regulatory recognition to support the firms in assuring their implementation. In any event, the regulator can play a role in promoting and sharing good practice in firms beyond the requirements strictly required by regulation.

Local versus global

The Consultation document recognises that FICC markets are global in scope and acknowledges that "many of its recommendations are likely to require global discussion- whether with industry bodies, or with EU and other international authorities (including standard setters, such as the FSB and IOSCO, and central banks". The Consultation also notes that "where appropriate, the Review will also make recommendations for regulatory reforms at a domestic level, subject to the constraints of the current EU legislative framework".

Achieving international coordination in the implementation of any response, whether regulatory or voluntary, will not just be desirable, but critical to their success. Although a large proportion of the FICC markets are hosted in London, they also operate in the rest of the world and their participants are global. This means that action taken solely in the UK is unlikely to be effective. Leaving to one side potential damage to that part of the UK economy benefitting directly from the activity generated by the FICC markets in the UK, if the UK acts unilaterally it will not have the desired impact, but simply lead to market participants moving activity elsewhere.

This will mean that the objective of securing fairer and more effective global markets will be frustrated, to the potential detriment of users wherever located.

It is, therefore, vital that if recommendations emerge and which meet the relevant good regulation tests, every effort should be made to secure international agreement on their implementation globally, including across the EU, at the same time. If this is not done, the global nature of the FICC markets, which is different in character to that in, say, the banking or insurance markets, means that the problems which the FEMR seeks to address will not be solved. It is just possible that there may be some particular UK-specific regulation or market practice which might benefit from reform without having adverse consequences, but the case for unilateral action by the UK would need to be extraordinarily strong.

Conclusion

To summarise, the IRSG supports wholeheartedly the intention of the FEMR to restore confidence in the FICC markets following the shortcomings which have come to light. This is necessary for all users not just in the UK but globally. However, to achieve this, and given the all-pervasive role of those markets, its recommendations have to be very precisely and soundly calibrated, taking due account of assured changes in behaviour which market participants can bring about themselves and, unless there is a case otherwise, introduced simultaneously in all market places where those markets operate.

Yours sincerely,

Rachel Lomax, Chair, IRSG