The Bank of England
Fair and Effective Markets Review
Threadneedle Street
London
EC2R 8AH

29th January 2015

Dear Sirs

Re: Fair and Effective Markets Review, Consultation Paper

FMR Advisory welcomes the opportunity to comment on the consultation paper issued by the Bank of England, Her Majesty's Treasury and the Financial Conduct Authority, as part of the Fair and Effective Markets Review (FEMR).

FMR Advisory Ltd was established to advise financial institutions in the preparation and implementation of MiFID compliance and Conduct Risk mitigation. Robin Poynder, the founder of FMR Advisory, has over 30 years experience in the OTC financial markets, both as a trader and business manager. During the last six years Robin has been actively engaged in work around the new G20 commitments to Regulation of the OTC markets, with a strong focus on the new MIFID, as well as more recently helping institutions in their work around conduct risk.

Executive Summary

In the interests of efficiency, FMR Advisory has responded to those questions where it is felt that the embedded expertise and experience will be of most interest to the review, with a focus on 'Box 7'.

- Many of the review topics will be at least partially mitigated with a more proactive and open communication between the customer and the firm; covering areas such as the capacity in which the firm is acting, how the trade will be transacted and what actions may be taken by the firm following execution to manage their risk.
- Several areas would become less of a concern were there more clarity around when a firm is acting as agent or principal. Often the firm will quite correctly operate in both capacities and the distinction may be made internally to the firm, across different roles/people.
- A strong encouragement and subsequent endorsement of a Model Code of Conduct will ensure much risk of incorrect behaviour will be mitigated and driven out of the market, often as part of a wider Conduct Risk programme.

Responses to Questions:

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What does 'Fair and Effective' mean for FICC markets?

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?

A1. The proposed definitions in section 3 appear appropriate and well reasoned. The explicit acknowledgement around MiFID 2 provisions and balancing transparency with effectiveness (e.g. resulting market liquidity) is well taken. The tone of the text appears to aim for an overall 'fair' market, without imposing some kind of goal around 'equality of all' - it is important to recognise the inherent differences between a retail investor and an institutional trader, without seeking an unfair advantage for either. Existing legislation that has come into law subsequent to the 2007/09 crash is already dramatically affecting liquidity, as the resulting effects of the newer regulations impact use of capital and risk appetite when considering the substantially higher costs of trading as a principal in OTC markets. This trend should be taken into account when considering regulatory action and the balance between fair and effective.

A framework for evaluating fairness and effectiveness

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?

A2. Considering the recent market abuses, such as took place around LIBOR or the WMR FX Fixing, it would appear that the abuse has arisen from a small number of individuals behaving improperly, rather than due to an inherently structural problem. Discussing recent abuses with market participants, allied with many years experience in interacting directly with market participants as traders, sales people and customers, suggests that the vast majority of individuals operating in the financial markets would never wish to operate outside of best practice, let alone outside of the law. Bad practice could be positioned as falling into two broad camps; those who willfully behave outside best practice for some commercial benefit, personal or institutional, and those who have followed some kind of accepted 'norm' that has crept into the market over the years.

Whilst neither can be considered acceptable, there is a significant difference in approach and intent. A consistent and clear set of market standards of practice, that is recognised and driven out through firms, has not happened. Codes of Conduct do indeed exist and have done so for many years. The ACI Model Code was first published in 1975 for instance and during the 1980's was found and followed in virtually all dealing rooms around the world. As markets developed and new asset classes and institutional traders proliferated, the Code became less commonly found, and firms put less focus on conforming to this Code.

With the above in mind, the landscape in which traders operated altered subtly over the years such that a clear set of guidelines or code ceased to apply as widely. A trader's moral compass became more individually established and less institutionally driven – and therefore far more variable across business lines and institutions.

Barrier and Digital Options

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?

A3. We contend that there is not an inherently different fairness/effective risk involved in trading barrier/digital options when compared to any other instrument. In our view there are two key points. Firstly the institution that has offered a price to a client when acting as principal and then traded; is immediately in a position where the market risk that they have just established implies that they will need to act in the markets against the interest of that client position, in order to hedge their risk. This is true for any instrument and may take place immediately or over time. Secondly and perhaps most importantly, the client should be made aware prior to executing any trades that in the normal course of business the institution may subsequently operate in the markets in such as way that the result could potentially negatively impact the client position, not least bearing in mind that the institution will not have a clear picture of the client's wider trading book or overall positions. Any 'fairness risk' is mitigated by ensuring that in both the initial client engagement contract and each option (or other instrument) contract to trade; there is a clause that explicitly informs the client that this kind of operation may take place. A clear and open communication with the client around how business is conducted should be an underlying principle to all client relationships.

Market Microstructure

Q8: Are there risks associated with internalisation and last look practices? Are

there barriers preventing increased pre and post-trade transparency in foreign exchange markets?

A8. As highlighted in A3 there should be a clear and open communication with clients around how business will be transacted with them. Last Look is a functionality that has been in operation for many years and has evolved along with the electronic markets. Last look can take several forms and work to mitigate a variety of similar but distinct risks. There are some clients who actively request last look in different forms, whether asymmetric or symmetric; and there are others who may not know that last look exists in name, but who are happy with the service they receive because of Last Look being a part of the pricing mechanism. FMR Advisory recently held a Round Table on this topic where many of the related issues were discussed in depth and the resulting report is attached as part of our response.

Standards of market practice

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?

A27. The concept of using a reference point model code of conduct, such as the ACI Model Code, should continue to be pursued. Whilst regulators are encouraging an industry solution, the industry is waiting for a steer from regulators as to which code to support and build out. This impasse will hopefully resolve shortly, due to the necessity for action. Whilst the Model Code is not complete in coverage and in some sense could be held as always requiring updates, it has been considerably developed over many years and must surely be a core from which to work. The information contained within the Model Code is clear, with explicit examples setting out real life situations and how the Code of Conduct applies in given situations.

In order to make this use more effective, the Code requires a constant programme of development to ensure that it continues to be up to date with current market best practice. Secondly, the regulatory community needs to make it clear to the industry that internal codes are not enough and that a common externally managed code is required and to which compliance will be measured. It is only with this external push that many institutions will focus on some kind of industry standard as opposed to solely their own well-intentioned and quite possibly well-written internally defined code.

Standards of market practice

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?

A28. The very nature of the OTC market requires that a firm acts as principal much of the time when transacting with customers. Given that there is no central market place into which the firm can execute on behalf of the customer, for many of the instruments required, institutions put their own capital to work in pricing a customer's particular trade. As soon as the customer has traded, the institution is potentially in conflict given that the position recently acquired is opposite to the customer's; although the reality of running an OTC business means that often the position is in reality swallowed up within a larger book of interest. The institution is frequently required to act as both principal and agent to a customer, depending on the customer's requirements in a given instrument and their instructions on how to execute a given trade. The challenge of managing this binary relationship with customers can be at least partially mitigated with clear separation of some duties at the individual person level (e.g. Sales vs. Trader) and through clear communication with the customer at appropriate times. Both the firm and the customer should always be aware of how the institution is acting for a given trade, be it as principal or agent. As indicated in 'Box 7', many of the subsequent issues do stem to some extent from a lack of clarity in the above situation.

Regarding standards for external and internal sharing of information, the ACI Model Code reflects on this. There are examples within the Code that help to clarify this somewhat and building a library of further examples should be encouraged.

The lack of granular client classification with regards to suitability is already a challenge and once MiFID II is live and implemented, this will become far more challenging for EU firms, given the profound effects of investor protection that will enter the wholesale markets. The very different approaches taken by various jurisdictions towards investor/customer protection do drive, with some inevitability, mobility of trading across different regimes.

Standards of market practice

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?

A29. With regards to MiFID II, there is currently a natural lack of clarity regarding the details of investor protection, not least due to much of the industry feedback to a prior consultation paper not being incorporated within the latest ESMA proposals for finalisation of the technical standards. The industry is trying to get to grips with some precision around implementation – and a continuing programme of education from the regulatory world as this develops is to be hoped for.

However MiFID was not aimed at some of the conduct risk that has emerged as an issue over the last few years and the work being conducted by IOSCO around conduct should clarify this important area across the financial market jurisdictions, once guidance has been issued.

As mentioned above in A27, one of the challenges in an industry-led approach towards an industry standard code is that firms are not sure which code to stand behind, if there should indeed be a single code, and are waiting for regulatory guidance. A proliferation of codes will not help this situation. A pragmatic approach would appear to be to take the most developed and practical code, encourage further evolution of that code and support for this code from the industry. We believe that strong support for a single code will be far more effective than a new set of aligned but inevitably different global legislations.

Standards of market practice - *Can the industry help to establish better standards of market practice?*

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

As stated in A27 and A29, we believe strongly that an industry-led code is by far the most pragmatic and sensible solution to ensure best practice across the global markets. An industry-led code can cross jurisdictional and political boundaries and be developed and updated as a living document, far more easily than pieces of legislation across different jurisdictions. It is most important to provide clarity of focus to the industry institutions by giving regulatory support to a single code, or perhaps a single code per asset class, in order to ensure that every institution is following the same code. The regulatory focus on a given code through reference to the code in, for instance, the UK senior person regime, will ensure that good conduct is driven consciously into and through all institutions.

Standards of market practice - *Can the industry help to establish better standards of market practice?*

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?

The ACI Model Code already has a programme of regular development to ensure it remains up to date. It was republished in 2013 and will be republished again early in 2015. This programme could be made more regular and the library of examples built out further, with a deeper and more active industry engagement. This engagement will inevitably come should the industry understand that their behaviour will be measured against this code.

Any industry code will at this stage have differences when compared to others such as the NIPS code in the UK or the Code of Conduct and Practice in HK. This could be reconciled whereby a new approach in each jurisdiction recognises the (to be recognised) new Code of Conduct as the underlying Code and has the agreed ability to publish a set of local variations as appropriate. With this approach a single global Code can be implemented, while also allowing regulators in various jurisdictions to adjust to local constructs as appropriate.

Communicating to trading teams will take place immediately the institutions have clarity on the Code to follow. No institution, or indeed the vast majority of traders, would wish to be outside best practice - once clarity of what constitutes best practice is available.

With regards to customisation across asset classes, there are some common principles and approaches that are common across all asset classes, such as client confidentiality. Best practice has slight variations in detailed implementation and these can be covered partially with separate sections that cover a given instrument. Where asset classes differ significantly, could be covered in separate sections as above and partially/importantly through real-life examples in the appendices that reflect specific use-cases for the various instruments or trading life-cycles of different asset classes.

Responsibilities, governance and incentives

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?

It is now well understood that the tone at the top of an organisation should drive the tune in the middle. Management programmes are in place in almost all institutions to ensure that the conduct of all staff is of the appropriately high standard. A compensation structure that rewards those who bring in substantial revenues for the firm is well established and whatever the tone, tune or monthly discussions, staff will be driven predominantly by the annual targets that they are given. One method of swinging the balance towards best practice of behaviour and to run alongside the focus on revenue-generation, would be measurable targets around behaviour. Meeting these targets could be a pre-requisite for a revenue-based bonus becoming payable. The balance of reward between revenue generation and behaviour will find different percentages across different firms, however the principle of making best practice behaviour a significant proportion of any potential reward will inevitably drive a positive outcome.

We do appreciate the opportunity to share our views on this review and would be glad to follow up as appropriate, should that be helpful. I can be contacted as below should you wish to discuss any of the above responses.

Yours sincerely

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