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To Whom It May Concern

How fair and effective are the fixed income, foreign exchange and commodities markets?

PwC welcomes the opportunity to respond to the Fair and Effective Market Review's (the Review) consultation paper. The fixed income, currency and commodity (FICC) markets underpin major financial transactions in the global economy. These markets also play a vital role in determining the costs of borrowing for households, businesses and government, exchange rates, and commodity prices that affect the real economy in the UK.

We support all initiatives that aim to boost confidence in the UK's wholesale markets, to maintain London's status as an EU and global financial centre and to help shape the UK and international policies that govern markets. We believe that integrity and confidence are vital attributes for the effective operation of these markets, and fully support the aims of the Review. We think that improving fairness and effectiveness should be a shared responsibility amongst all market participants, including individuals, firms, and regulators, as well as professional services firms like ourselves.

We welcome that the Review recognises that there are a number of existing regulatory initiatives that have an important bearing on the fairness and effectiveness of the FICC markets. Firms operating in the FICC markets are undergoing a high degree of change as they implement or prepare to implement a broad spectrum of regulatory initiatives. We encourage the Review to consider the impact of each of these regulatory initiatives, both those recently implemented and soon to be implemented in its assessment of whether measures exist to tackle the risks in the FICC markets. In addition to assessing regulatory initiatives in isolation, we encourage the Review to take into account the cumulative impact of these regulatory changes.

Given the number of regulatory initiatives recently implemented, in progress and planned, we believe that improving and upholding standards of culture and integrity in firms is key to improving the fairness and effectiveness of the FICC markets. Although regulation and supervision can encourage these standards, ultimately it is down to firms to make improvements and ensure that they and their employees achieve and maintain these high standards.

We hope that our comments will be helpful and we would be pleased to discuss these observations further with you.

Yours faithfully,

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Drivers of the review

The Review argues that public trust in the FICC markets has been damaged by a series of high-profile abuses. We agree that abuses in the FICC markets have further eroded public trust in the financial services industry as a whole. Restoring public confidence in financial services is very important and improving confidence in FICC markets is a cornerstone of this wider effort.

Delivering high standards of behaviour and integrity in both retail and wholesale markets is fundamental for restoring public trust in financial markets. In some cases, firms and individuals have not lived up to the standards and behaviours that the public and regulators expect of them, and there have been serious consequences for markets and consumers. So it is entirely appropriate to consider how to ensure that high standards of behaviour and integrity are consistently maintained across all parts of financial services.

Existing regulation

A significant number of regulatory reforms have been introduced since the global financial crisis to restore confidence in financial markets and financial intermediaries. Regulations have been targeted to increase transparency and accountability, stimulate competition and make markets more resilient to future shocks. These changes have originated at different levels: domestic, European and international, and will significantly alter the landscape of financial markets in the UK once fully implemented.

We believe that many of the perceived problems highlighted in the consultation paper are likely to be addressed by legislation that has recently come into effect or will come into effect in the near future (Table 1).

Table 1

Objective	Regulatory initiative
Market microstructure	• MiFID II • EMIR • Dodd-Frank VII • Basel III
Competition and market discipline	• MAD/MAR • CMA and FCA competition mandate
Benchmarks	• UK regulatory framework for benchmarks • EU Benchmark Regulation • IOSCO & FSB benchmark reforms
Standards of market practice	• FCA Principles • IOSCO Principles
Responsibilities, governance and incentives	• Senior Management and Certification Regime • MiFID II • EMIR • CRD IV
Surveillance and penalties	• FCA 'credible deterrence' • MAD/MAR

We agree that a primary aim of the Review should be to take stock, and ask whether or not the extent of regulatory, organisational and technological change since the crisis will be sufficient to ensure FICC markets are fair and effective in the future. At this point in time, it is difficult to fully assess this because some regulatory initiatives are yet to take effect and so their impact is difficult to predict in meaningful ways. For this reason, we urge caution in introducing further overlapping, UK-specific regulatory initiatives.

Culture

The Review notes that there have been a number of initiatives aimed at improving culture and behaviour at firm and individual level, including the UK Parliamentary Commission on Banking Standards (PCBS), the Banking Standards Review Council (BSRC), and widespread efforts by individual firms to strengthen internal controls. In line with these initiatives, we believe that improving and upholding standards of culture and integrity both at organisation and individual level is key to enhancing the fairness and effectiveness of the FICC markets.

As the PCBS noted in Changing Banking for Good, many of the failings in the banking sector in recent years had common roots, often originating in the a failure of governance and standards at the most senior levels of firms. Incidents across both the retail and the FICC markets may be indicative of such failings, with the culture of organisations underpinned by individual behaviours that did not align to organisations' desired values and behaviours.

We support the FCA's view expressed at the 2014 FCA Enforcement Conference that rules cannot be simply put in place that paper over such cultural deficits. Excessive reliance on rules and regulations can encourage firms and individuals to fail to take responsibility for understanding their culture, what improvement is needed and how it impacts the risk management of the firm.

In addition, given the differences in culture between retail and the FICC markets, and indeed between different firms in the same sector, we feel that there is no single one-size-fits-all solution to improving a firm's culture and embedding ethical behaviour. It is the role of the leaders of firms to set the 'tone from the top' and define what 'doing the right thing' means for it as an organisation, for its people, and for all its stakeholders. As such, we feel that culture and standards of an organisation are a matter for the organisation itself and cannot be imposed by regulators implementing detailed rules. Every individual in the firm has an important role to play in maintaining an appropriate culture and standards.

In line with this view, we believe that an organisation's culture and ethical tone is set by leadership through alignment of their behaviour to the desired purpose, vision, values and behaviours of the organisation. This culture must be supported by putting key behavioural reinforcers in place such as performance management, personal development and training, risk management and two way communication. These measures need to be reinforced by appropriate reward and recognition schemes and disciplinary procedures.

While recognising the importance of a clear 'tone from the top', we note and support the Financial Reporting Council's (FRC) view that in order to ensure the appropriate culture is in place, it is not sufficient for the board simply to set the desired values. The board also needs to ensure they are communicated by management, incentivise the desired behaviours and sanction inappropriate behaviour. The board should also regularly assess whether or not the desired values and behaviours

have become embedded at all levels. We would also suggest that the role of supervisors within firms is important in this sense; these individuals can help to ensure that the behaviours and culture espoused by senior leadership are understood and adhered to at all levels.

Benchmarks

Benchmarks are a central component of the FICC markets and alleged benchmark manipulation is one of the key drivers of the Review. The Review notes that given the importance of benchmarks within the FICC markets, it is important to evaluate whether or not existing regulatory initiatives provide a comprehensive solution to problems that have arisen in recent years.

It is difficult to say whether current domestic and international initiatives by industry and regulators to improve the robustness of benchmarks go far enough when the majority of these initiatives are not yet finalised. As we set out in our response to HM Treasury's consultation paper on bringing further benchmarks within the scope of UK regulation, where the risk of error in a benchmark poses a risk to the wider economy, it is right to bring it into the scope of regulation. On this basis, we support the extension of the regulatory framework to additional benchmarks as suggested by the Review and now being taken forward by HM Treasury and the FCA.

In its recommendations to HM Treasury on the additional benchmarks to be included within the scope of UK regulation, the Review noted that the European Benchmark Regulation will replace the UK regulatory framework (though not the UK criminal framework). Given that the Benchmark Regulation is still going through the EU legislative process and is not yet finalised, it seems premature at this juncture to make a reasoned assessment on whether any further initiatives are required. This is especially the case when work undertaken by the Financial Stability Board (FSB) on reforming interest rate and foreign exchange benchmarks has not yet been implemented.

As a leading provider of external assurance for regulated benchmarks, we have seen first-hand the improvements in control environments that including benchmarks within the scope of regulation can achieve. We therefore welcome the proportionate extension of the UK regulatory framework to the seven additional benchmarks as proposed by the Review to HM Treasury. However, given the unfinished nature of international work on benchmarks and noting the global nature of the FICC markets, it is too early to make an assessment on whether any further work is required.

UK competitiveness

London is one of the world's most important financial centres for the FICC markets. The FICC markets are global by nature and introducing UK-specific regulatory initiatives risks placing UK participants in the FICC markets at a disadvantage. Therefore it is important to have effective coordination of any new regulatory measures across jurisdictions to ensure that the way markets work can be improved without risking detriment to the participants in any one jurisdiction.

We support the UK government and the UK regulatory authorities taking a leading role in international discussions on trading practices. Action taken at a global level, in fora such as the FSB, has the advantage of creating a more level playing field for market participants across jurisdictions while improving robustness of wholesale markets.

We recognise that the reputation of the City of London is important to the strength of the wider financial and professional services industry in the UK. Therefore, while we caution against disproportionate UK-specific regulatory initiatives, we support measures already taken to improve standards and confidence in UK participants in global markets. In particular, we note the introduction of the Senior Manager and Certification Regime, and the extension of the scope of the UK regulatory framework for benchmarks.

Transparency

Increased transparency is sometimes offered as a solution for improving standards in financial markets. But increased transparency is not a panacea and there is a danger that a blanket increase in transparency across FICC markets could be detrimental to the interests of wholesale participants who may have to pay more for certain protections that they do not necessarily require. There is a risk that increasing transparency requirements for participants in FICC markets could mean that these costs are passed on to consumers. We provide a theoretical example of how this could happen in Annex 1.

There is a greater case for increasing transparency for regulators. Notwithstanding the increased transparency requirements introduced under the transaction reporting requirements for EMIR and MiFIR, there is greater strength in the argument that there should be increased transparency to regulators for the purposes of identifying instances of market abuse and build ups of systemic risk.

The Review makes the argument that prices should be available to 'relevant parties'. There is clearly some debate to be had as to who or what constitutes 'relevant parties' and this is likely to differ across products and markets. As a generalisation, it can be argued that 'relevant parties' would not include making the price public in all cases, as this would risk detriment to both buyer and seller. Requiring firms to be able to explain to the regulator how they arrived at a particular price is different and possibly more appropriate in these markets, than making prices public.

Conflicts of interest/information asymmetries

Within the FICC markets, some information asymmetries do exist, but these are often a product of the specific nature of those markets. These markets have evolved to meet the specific needs of investors and corporates and their current form is a reflection of this organic evolution.

Given the participation of firms of all sizes, including producers and consumers of commodities, commercial firms with foreign exchange exposures arising from their international business and similar non-financial firms in the FICC markets, it is inevitable that market participants will have access to a diverse array of market data. Smaller firms may have limited internally generated market research, while larger non-financial firms may have insight in certain markets that rivals, or even exceeds that of large banks. All non-financial firms will have information about their own business interest and activities, including their own motive for trading.

Many of the FICC markets have long established transparency requirements relating to underlying commercial activity which may affect market price. These have developed to address the natural asymmetries between market participants and the need to ensure that data which affects the market as a whole is shared while data which is commercially significant to individual firms is not.

It would seem legitimate for a firm to use FICC markets to support its wider non-financial business, and to that extent the financial trading activity is driven by commercial imperatives. What seems less legitimate is for a firm to seek advantage in financial markets as a result of its commercial information. This distinction is not always clear – a firm which uses the FICC markets to manage commercial risks which it anticipates but which are unknown to other market participants is still employing a relative advantage in those markets. In the absence of a clear and objective line as to when and how market participants may use price sensitive information, judging whether a particular trading activity is appropriate instead becomes a question of conduct for FICC market participants. Do individuals seek primarily to manage their commercial risks or to take advantage of information asymmetries? Does the firm encourage proper behaviour or does it instead provide incentives for staff to maximise trading returns without regard to the commercial activity of the firm? Policy makers have approached this distinction between commercial risk and financial profit in some areas of existing legislation, notably Regulation (EU) 1227/2011 on energy market integrity and transparency (REMIT). We provide further details in Annex 2.

Concluding remarks

We reiterate our support for the aims of the Review. The FICC markets play an important role in underpinning financial transactions in the global economy. Clearly, there have been instances of misconduct in the FICC markets that have undermined their credibility and further eroded public confidence in financial markets and services. We fully support the work that has been done and work that is ongoing to improve standards in the FICC markets and in financial services more broadly.

As set out above, there is a broad regulatory agenda of initiatives aimed at addressing problems associated with the FICC markets and highlighted by the Review in its consultation paper. We encourage the Review to take into account that many of these regulatory initiatives have not yet been finalised or implemented. For those that are in effect, it is arguably too early to make an accurate assessment as to their individual or cumulative impact.

The Review seems to have an appreciation that not all FICC markets are the same, and we welcome this indication. When considering whether further regulatory intervention is needed to improve the fairness and effectiveness of the FICC markets, we urge the Review to consider the individual purposes and characteristics of these markets, and any specific failures, to arrive at specific solutions for specific markets and products.

We believe that improving and upholding standards of culture and integrity is key to enhancing the fairness and effectiveness of the FICC markets. As we have set out, we firmly believe that an organisation's culture and ethical tone is set by leadership through alignment of their behaviour to the desired purpose, vision, values and behaviours of the organisation. Though regulation and supervision can encourage this, ultimately it is down to firms and individuals within them to make improvements and ensure that high standards are achieved and maintained.

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Annex 1: How increased transparency requirements could increase costs for consumers

Banks operating in commodity derivative markets take bilateral positions with end user clients who wish to manage their exposure to price movements in the underlying commodity. An airline might enter into a position with a bank to manage its exposure to changes in the cost of fuel and so enable the airline to set ticket prices for customers in advance. The bank will manage its own risk through a combination of positions taken with other clients and its own trading on commodity derivative markets. For particularly large and/or long dated positions, the bank will engage in correspondingly more extensive and complex trading to manage its risk. Increased transparency provides other market participants with information to anticipate the likely exposure of the bank. Even if other market participants do not know who has taken a position on behalf of the airline, the market as a whole can determine that someone has a large position that they will need to manage. This information places the bank at a disadvantage in the market and so increases the cost of managing that risk (as the market moves against the bank in anticipation of future trading). Any market participant anticipating increased risk management costs will price those costs into the bilateral trades with its client (in this case, the airline). Those clients will in turn pass the increased cost on to their own customers (e.g. the family booking holiday flights in advance). The challenge when determining the correct level of transparency in FICC markets stems from this interconnectivity, and policy makers should recognise that the benefit of increased transparency may accrue to market participants while the cost is ultimately born by consumers in the real economy.

Annex 2: The distinction between commercial risk and financial profit – the experience from REMIT

Policy makers have approached this distinction between commercial risk and financial profit in some areas of existing legislation. Regulation (EU) 1227/2011 on energy market integrity and transparency (REMIT) addresses (amongst other things) insider trading in physical power and gas markets. Art 3 covers insider trading, but Art 3(4)(b) explicitly exempts

"transactions entered into by electricity and natural gas producers, operators of natural gas storage facilities or operators of LNG import facilities the sole purpose of which is to cover the immediate physical loss resulting from unplanned outages, where not to do so would result in the market participant not being able to meet existing contractual obligations or where such action is undertaken in agreement with the transmission system operator(s) concerned in order to ensure safe and secure operation of the system."

The goal is to enable firms to manage their commercial risk without disclosure, and only then introduce a prohibition against taking advantage of price sensitive information. We would not advocate that REMIT be taken as a direct model for future regulation, but simply as evidence that our proposed distinction is not new.