SUBMISSION TO UK FAIR AND EFFECTIVE MARKETS REVIEW
RESERVE BANK OF AUSTRALIA

Fixed Income, Currency and Commodities markets play a pivotal role in the functioning of financial markets and hence of the economy more generally. Trust in the fairness and effectiveness of the operation of FICC markets is critical. While this is true of all financial markets, it is particularly the case for FICC markets given their more bespoke nature. Hence the RBA welcomes the opportunity to comment on the issues raised in the consultation document.

The RBA's submission does not address the questions raised in the consultation individually. Rather it aims to provide more general comments, referencing individual questions where appropriate.

The comments in the submission are divided into the two areas identified in Table A of the consultation document: the structure of FICC markets and the conduct and behaviour of FICC market participants. In our opinion, and responding to question 2 of the consultation document, there is some scope to improve the fairness and effectiveness of markets from changing market structure. However, one significant complication is that market structure in many FICC markets is undergoing considerable change at the moment. Instead, this submission sees more opportunities for improvement and reform in the area of conduct and behaviour. Structure can reduce the opportunities and incentives for market manipulation and unfair practices, but in the end, it is unlikely any market structure can be made immune to misconduct. If the culture in place condones manipulation, then it will be prevalent almost regardless of the market structure. Hence it comes back to ensuring appropriate behaviours are followed and this is where we see the greatest opportunity for improving the fairness and effectiveness of markets.

Structure

Generally, we do not think that there is one overarching market structure that works best for all markets. That is, care should be taken to avoid a one-size fits all view of market structure and regulation. Different market segments do necessarily have differences in market structure for them to operate effectively. OTC markets, which many FICC markets are, will have different market structures and functioning from exchange-based markets.

As the consultation paper acknowledges, a notable feature of many FICC markets is their bespoke nature. In many cases, this is an intrinsic characteristic of FICC and should be taken as a given, rather than necessarily as an opportunity for reform. Their fundamentally bespoke nature also limits the scope to move FICC markets to exchanges in many cases. Indeed, there could be adverse effects from doing so. In particular, there are dangers in the equitisation of FICC markets, as a number of problems that have arisen in the US equity market in recent years have demonstrated.

Take for example, the corporate bond market. Outside of a few large global corporations, most corporates only issue bonds occasionally. Hence each issue will be bespoke and relatively small in size. Given that, it is likely that many corporate bonds will be relatively illiquid or infrequently traded. Hence price discovery in the corporate bond market will also be more complicated. It will be difficult to determine the "true" market-clearing price. Brokers in the corporate market must necessarily use judgement in pricing the security. As a result, some element of caveat emptor must be prevalent.

Buyers and sellers are either willing to transact at the quoted price by the broker or they're not. They have the option not to trade if they do not like the quoted price.

More generally, given the OTC nature of FICC markets, some reliance on caveat emptor must be present, notwithstanding the discussion of this issue in the consultation document. This is particularly true for sophisticated investors transacting in illiquid markets. We acknowledge the point raised in the document that too much faith has been put in caveat emptor, but at the same time, there remains some need for it. Market participants should be able to assume that some basic principles of behaviour are being followed (see below) but there is also some onus on them to be aware of the conditions of the market they are transacting in. Related to this, there is considerable scope for the buy-side to impose more discipline and monitoring of appropriate behaviour.

One can think of a spectrum of FICC markets ranging from foreign exchange on the one hand, where the product being traded is homogenous with generally good liquidity, to small corporate bond issues on the other with infrequent trading. Price verification (in the sense that the transaction has been conducted at a "fair" price) in the former is relatively straightforward whereas in the latter it is very difficult. The degree of reliance on caveat emptor can be seen as increasing across that spectrum. A participant in the foreign exchange market should presume that the market structure is delivering appropriate outcomes without continually needing to verify that is the case, whereas a participant in the small corporate bond market should be aware of the bespoke nature of the market they are transacting in.

The consultation document raises the issue of competition in FICC markets. Most FICC markets have a small number of large participants (around six to ten) and the share of business accounted for by those participants has often increased in recent years. However, compared with many other markets in the economy, FICC markets would be seen as having a competitive structure. In the case of the foreign exchange market, the 6 largest firms have around 60 per cent of the market, with a large number of companies in the remaining 40 per cent. In many markets this would be regarded as healthy competition.

Nevertheless, it is the case that the market structure is changing. The larger participants in the market tend to have a significant edge in technology which can limit the degree to which other participants can provide effective competition to them in some aspects of the market and could be regarded as a barrier to entry. However, at the same time other participants are able to provide different competitive offerings to their customers by taking advantage of the changing technology and the increased electronification of the foreign exchange market. In other FICC markets, new entrants have emerged, for example Citadel's growing presence as a broker in a number of markets.

While technology has provided something of a barrier to entry because of the large capital spending required to compete with the product offerings of the largest FICC businesses, at the same time technology has also reduced transaction costs in a number of areas. For example, bid/ask spreads for foreign exchange have fallen substantially in the wholesale market, but by even larger amounts in the retail end of the market. Smaller businesses are now able to receive similar pricing services to larger participants because of the reduced technological cost of providing it to them. With the growing importance of transaction cost analysis (TCA) in FICC markets as a means of verifying best execution, technology has enabled this to be provided at a cheaper price to a wider range of customers with considerable change and progress ongoing.

Moreover, in light of recent regulatory developments, which have contributed to a reduction in broker capacity in some FICC markets, there is potential for more buy-side to buy-side trading to occur. These regulatory developments have seen (as intended) the willingness and ability of banks to warehouse risk decline, contributing to an overall reduction in market-making capacity. Liquidity has declined from its former levels (as intended), although whether this decline in liquidity is to worrisome levels remains an open question. But these developments are likely to cause real money participants to reconsider the way they manage their portfolios, taking account of reduced liquidity and potentially greater transaction costs. The consequent changes in market structure and functioning may be quite substantial. Time should be given to see how these changes play out in terms of delivering a 'fair and effective' structure for FICC markets.

Conduct

While there may not be much scope or need for regulatory change to the structure of markets to achieve the goals of the consultation document, particularly given the evolution that is currently occurring, there is considerable scope to deliver much better outcomes in the areas of conduct and behaviour.

The greatest assurance that fair and effective outcomes are being achieved in markets will come from the confidence that all market participants are maintaining appropriate standards of behaviour. It is here where the failings appear to have been largest in recent years. That said, it is not clear how endemic the behaviour has been. It appears to have been prevalent across most sections of the FICC markets but not across all participants. Hence care should be taken that solutions address the problems in the tails of the behavioural distribution without compromising the ability of the core part of the market to continue to conduct its business effectively.

Behaviour and culture are, definitionally, hard to regulate, and the primary driver of change must come from within organisations. Appropriate culture should be driven from the top of the organisation. While the deficient standards of behaviour that have been revealed in a number of FICC markets were not necessarily condoned by organisations, at the same time it seems to be the case that they were also not resisted very strongly. There appears to have been considerably greater focus on outcomes, in terms of profitability, rather than on the means by which those outcomes were achieved. The remuneration structures in many organisations further incentivised traders to focus on the ends not the means. Hence, the drivers of cultural change are likely to be internal rather than external. The fines levied on institutions for inappropriate conduct of late have, if nothing else, crystallised the cost of inadequate organisational culture.

That said, there are some external changes that can help to achieve better behavioural standards in the industry. One possibility is to introduce a licencing system for traders. Obtaining a licence would require a trader to undertake annual (external) training on appropriate market behaviour and conduct. A licence would be revoked by the regulator (most likely the securities regulator) in the case of inappropriate conduct. If a trader doesn't have a licence, they can't be employed in the industry. This would then address the current problem that traders who have breached behavioural standards are often reemployed elsewhere in the industry as future employers are often legally unable to determine the reason for cessation of employment. Ideally this licence would be globally portable in line with the cross-border nature of the FICC industry.

There are a number of initiatives currently in train in upgrading codes of conduct in the industry, most obviously in the foreign exchange market where the various foreign exchange committees are jointly working on a code of best market practice. One issue that has come through in that process, which is likely to be relevant in considering improvements to codes of conduct across the FICC industry, is that it quickly becomes problematic to be too prescriptive. Principles of appropriate behaviour are likely to be more effective in achieving outcomes that detailed descriptions of what is and is not appropriate. It is difficult to describe precisely what is allowable. The danger in doing so is that a trader may assume that if a form of behaviour is not expressly prohibited then it must be allowable. Instead, if the focus is on principles, the onus of the trader and their organisation is to focus on the nature of the behaviour rather the precise detail. In other words, it much easier to arbitrage the details than it is the principles. Moreover, general principles are likely to be more resilient to the continual evolution of the market.

One example of the problems that can arise is in describing standards for appropriate information sharing. In an OTC market, there are clearly some pieces of information that need to be shared in order to complete a trade. At the same time, there are clearly some pieces of information that do not need to be shared (eg, customer information). But in between these there is a large grey area where precise definitions are difficult. Similar issues arise with front-running, where it is very difficult to determine the difference between appropriate hedging and front-running. In many cases, they are observationally equivalent in terms of the trade patterns observed. One area where there is clear scope for improvement in this regard is that the sell-side should make it clear when they are acting as principal or agent in a transaction. The appropriate behaviour will vary depending on which of the two it is, but this should be clearly disclosed to the counterparty in the transaction.

In addition to greater enforcement of appropriate conduct from within an organisation and potentially through a licencing process, there is also scope for greater enforcement of appropriate conduct from the buy-side. While buy-side firms should be able to maintain a degree of trust in their counterparty, a greater focus by the buy-side on how their business is being transacted would help ensure appropriate standards are being met. This would be in line with the fiduciary duty of asset managers to their end investors that best execution has been achieved when they are undertaking transactions. While the capacity to do this might vary with the size of the institution, there would appear to be considerable scope for the buy-side to provide greater discipline on the sell-side with reprimands and/or sanctions for substandard behaviour or conduct potentially being imposed collectively by an industry organisation.

However, codes of conduct can only go so far. There needs to be stronger enforcement around these codes. As mentioned, there is onus on the institutions employing the traders to monitor and enforce them, there is onus on the buy-side too, but there would appear to be a need for enforcement from the regulators as well. Indeed, if the codes are deemed to be ineffective in achieving outcomes, then ultimately more stringent regulation may need to be developed, all this may well come at the cost of a worsening in market functioning.

Benchmarks

The consultation document poses a set of questions about the use of benchmarks. As the document notes, there has been considerable focus and regulatory effort in this area over the past year. Some time should be allowed to let those reforms that have come from these efforts, have their effect. In the case of foreign exchange benchmarks, a number of recommendations of the Foreign Exchange

Benchmark Group have been implemented,[1] but there are other areas where progress has been slower, particularly around charging for fixing business and separating the fix business from other transactions. If these shortcomings were to persist, a regulatory response may be necessary.

One area where more work could be undertaken is ensuring that benchmarks are not being overused or used inappropriately. Some financial products use benchmark reference rates only for historical reasons not for any sound financial reasons. Similarly, more due diligence could be undertaken by benchmark users to ensure that they are using benchmarks that are fit for purpose.

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1 http://www.financialstabilityboard.org/2014/09/r_140930/