

WMBA and LEBA Response to FSA Consultation on the FCA Approach to Financial Regulation

The Wholesale Markets Brokers' Association (WMBA) and the London Energy Brokers' Association (LEBA) (*together "WMBA"*) are the European Industry Associations for the wholesale intermediation of Over-The-Counter (OTC) markets in financial, energy, commodity and emissions markets and their traded derivatives. Our members are Limited Activity/Limited Licence firms (under CRD) that act solely as intermediaries in the said wholesale financial markets. As Interdealer Brokers (IDBs), the WMBA members' principal client base is made up of global banks, primary dealers and energy companies. The comments below should be seen in the context of WMBA members acting exclusively as intermediaries, and not as own account traders. (Please see www.wmba.org.uk and www.leba.org.uk for information about the associations, its members and products.)

Overview

1.1 WMBA supports the Financial Conduct Authority's [FCA] strategic objective of protecting and enhancing confidence in the UK financial system and its three operational objectives:

- Securing an appropriate degree of protection for the consumer;
- Promoting efficiency and choice in the markets for financial services; and
- Protecting and enhancing the integrity of the UK financial system.

1.2 It also supports the Government's proposal that the FCA must, as far as it is compatible with its objectives, discharge its general functions in a way which promotes competition.

1.3 However, as stated in the proposed HMT, "**A New Approach to Financial Regulation**", the WMBA also agrees with the principle that "*the key to any new approach should be proportionality, the principle that a burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected to result*".

1.4 We note that it is the FCA's stated position to "recognise that there are important differences between wholesale and retail markets" (Para 3.5) and "will adopt a differentiated approach to protecting different categories of consumers" (Para 3.6). In relation to this, we would emphasise that it is paramount that there is a real recognition of the need to avoid excessive regulation and constitute a value for money proposition for wholesale markets. The WMBA stresses the importance of making sure that these statements are made good in practice and therefore that the FCA embraces proportionality and avoids 'scope-creep'. In light of the wider retail mandate given to the FCA, we highlight the risk that in focusing too strongly on retail issues, the unintended consequence of regulatory COB burdens that are not proportionate or relevant to wholesale market participants may result.

1.5 To ensure that a proportionate approach to regulation is implemented, WMBA believes that the FCA should define a distinct supervisory unit in order to concentrate on the wholesale market sector in general and on market infrastructures within that. As with the current FSA rulebook, supervision should be tailored and made relevant to the separate market sectors with only those firms with direct contact with the retail sector being subject to detailed COB requirements.

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1.6 In order to deliver the financial service sector contributions and the regulatory objectives set out above, the WMBA would urge the FCA to reconsider its position regarding the importance of competitiveness and include its facilitation as a key factor required to be taken into account in future regulation. Whilst WMBA concur with the Government that financial stability is indeed the platform for sustainable growth and success, this does not remove the specific need for a regulatory recognition of the importance for UK firms to remain competitive and for authorities to pay due regard to the need to facilitate and foster competitiveness.

1.7 With regards to competitiveness, the current wave of mergers across market infrastructures will likely establish monopolistic or near-monopolistic providers of essential market services and that their position and ability to dominate the market will be enhanced significantly by regulatory policy designed to encourage as much trading as possible to take place on organised trading venues, financial market infrastructures and to be centrally cleared by CCPs (*most of which are vertically integrated within exchanges*). Current market and regulatory momentum are delivering increasingly dominant positions for market infrastructures in execution, clearing, post-trade and market data services. All of these will impact on rights of clearing access, the pricing of services and facilities, the cost of (*and conditions of access to*) market data, the basis for licensing indices and the capability of new market infrastructure entrants to compete in execution and clearing.

1.8 The empowerment of FCA to independently monitor the behaviour of infrastructures relevant to market competitiveness and efficiency and choice in market services, the setting of fees and the terms and conditions for issuing licenses and affording access will be a critically important discipline on infrastructures with considerable market power and will play a key role in delivering on FCA objectives of market integrity and efficiency.

1.9 WMBA agrees that the FCA needs to aspire to command the respect of consumers and firms it regulates by attracting and **retaining** professional and dedicated staff who are equipped with the skills and knowledge of the financial markets in which the IDBs operate.

Detailed Comments

Supervision

2.1 The recent BOE/ FCA consultation paper titled "A New Approach to Regulation" stated that the Prudential Regulatory Authority (PRA) will be responsible for a small number of significant investment firms. However, Margaret Cole, in her speech on 28th June 2011 when launching this paper, also indicated "*for both conduct and prudential regulation, there is likely to be a small number of firms which will require a more active supervisory programme. This will apply to firms whose failure, even if orderly, could threaten the integrity of particular markets. One such example is Interdealer Brokers*".

2.2 WMBA respectfully requests clarification in respect of what constitutes "**a significant investment firm**" and whether interdealer brokers will, under the new regime, be regulated by the PRA or FCA in respect of prudential regulation. It has been suggested that IDBs are to be included within a putative classification of "Financial Market Infrastructures" (FMIs) including market intermediaries such as Regulated

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Exchanges, MTFs and post-trade settlement and clearing systems. Such a classification may be jointly regulated by both PRA and FCA. We would again and respectfully request clarification of whether such a regime is being considered. Following on from this, we also request clarification of the extent to which the FCA considers IDBs may create or mitigate systemic risk.

Chapter 2 – Scope

2.3 The WMBA notes that *“the FCA will regulate the conduct of 27,000 firms which carry out a very wide range of business in the retail and wholesale banking, investment, securities and insurance markets. It will also be responsible for the prudential supervision of around 24,500 of those firms”*. In light of the very large numbers involved here, we would simply repeat the need for proportionality to form the basis of the methods and degree of supervision deemed necessary.

The FCA’s recognition of the fact that these firms have *“a significant share of the global market in wholesale investment, insurance and banking sectors”* underlines the importance of UKplc as the prime wholesale market place for the world’s savings and investments. Operating around the world, but with very large concentrations of activities within the UK, the IDBs rely on the continued competitiveness of the UK as a safe and secure location for the ongoing business of our member firms.

Chapter 3 – Objectives and Powers

3.1 The WMBA strongly supports the FCA’s intention to *“focus more directly than the FSA has done on the workings of markets, including market power”* and that this *“will be an important change of emphasis in the new regulatory regime”* (Para 3.14 in the DP). In respect of this, we emphasise how actively IDBs compete amongst each other in terms of client service, efficiency and cost which may be in contrast to larger, more monopolistic, market infrastructures.

The WMBA would therefore support the concept that, while it is not intended that the FCA should become an economic regulator in the sense of prescribing returns for financial products or services, *the focus on competition will result in a number of outcomes, namely:*

- (a) Pricing oversight because, as it is put in Box 2, *“prices and margins can be key indicators of whether a market is competitive”*
- (b) *“Where competition is impaired, price intervention by the FCA may be one of a number of tools necessary to protect consumers”* – but not just to protect consumers, but also other “stakeholders” in the marketplace (e.g. regulated firms and competing infrastructures). Price intervention may also help to fulfil the market objectives of the FCA by addressing some of the factors that impact on those objectives, e.g. pricing of execution and clearing services, licenses and market data
- (c) The FCA developing a *“sound economic understanding of the way relevant markets operate”* to enable it to better act in the interests of competition

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- (d) The adoption of powers and measures in order to “reduce market power” (Box 2) (e.g. rights of clearing access)
- (e) The power to initiate enhanced referrals to the OFT where the FCA has identified a possible competition issue that may arise from a specific structural market feature or from an anti-competitive business practice.

Chapter 3 - Box 1: What is a consumer?

3.2 The WMBA has read the definition of consumer contained in Box 1 and consider that the current definition of consumer encompasses all participants in the financial services markets (including purely wholesale market participants who are currently afforded a principles based regime under MiFID). We would respectfully point out that the classification of a “*wholesale consumer*” would appear to us to be an oxymoron and unhelpful in defining the framework of regulation.

3.2 WMBA would respectfully draw the FCA’s attention to the HMT observation in this respect which states “*there are wholesale and market activities which do not directly form part of the transaction chain of products and services sold to retail customers. The scale and importance of these activities make it imperative that they are effectively and proportionately regulated in a way which recognises the particular characteristics of participants in these markets*”.

3.3 To facilitate this distinction, WMBA believes that, as a result of the different business models, client base and risks posed, the wholesale markets and its participants require a different regulatory methodology to ensure that a proportionate approach is implemented. Hence, it considers that the FCA should comprise units concentrating on the distinct characteristics of certain wholesale market sectors. Supervision should be tailored and relevant to activities undertaken by the separate market sectors with only those with direct contact with the retail sector and, hence, owing them a fiduciary duty being subject to detailed COB requirements.

3.4 The WMBA would be very willing to discuss the role of the IDB and the concept of a simplified rulebook for intermediaries, such as their members, dealing in the professional wholesale markets (*similar to the old FSA Inter-Professional Code - IPC*) and assist the FCA in establishing proportionate regulation in this respect.

Chapter 4 - Regulatory Approach

The WMBA notes the Government expectation that the FCA will intervene more strongly in “*retail financial services markets*”.

4.1 In relation to product intervention, we affirm that intervention is “*unlikely to be appropriate in relation to professional wholesale consumers*” (HM Treasury’s Cm8012), although it is noted that it will remain an option where “*wholesale products filter down or are distributed to retail consumers*” (Para 5.26)

4.2 In relation to credible deterrence (Para’s 4.13-15), there needs to be clear and transparent criteria which set out clearly how the conflicts between FCA’s understandable wish to have credible deterrence, ensuring that the punishment fits the crime and that

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regulated institutions and senior managers are capable of predicting the consequences of their actions will be addressed.

4.4 With regard to the issuance of warning notices, we welcome the FSA's acknowledgement in Para 4.15 of the need to "*balance the advantages of openness with the need to respect private rights and due process*" and "*consult the person concerned before issuing any information about the warning notice*".

Chapter 5 - Regulatory Activities

The WMBA strongly supports the FSA's expectation that:

- (a) "the FCA will be a risk-based regulator" and notes that it will have a "lower risk tolerance" than the FSA because of major mis-selling;
- (b) all firms will be subject to a minimum level of base-line supervision in line with international standards (Para 5.12), but prudential requirements should still be authentically risk-based and recognise that small firms, firms that pose no significant risk to the financial system and substantially differentiated firms (e.g. commodity firms) should still be entitled to appropriately differentiated treatment.

We support the assurance by the FCA that the oversight of each differentiated regulatory firm will "need to be tailored to reflect its own particular set of issues" and that its approach will reflect a firm's "business plan, risk, appetite, remuneration mechanisms and identified internal and external risks".

Paragraph 5.12 Prudential Supervision

5.1 WMBA is concerned with the FCA's interpretation of the role of the Interdealer Broker as expressed in the following section of this paragraph;

*"Prudential supervision: ... As with conduct regulation, there is likely to be a small number of firms whose failure, even if orderly, could threaten the integrity of a particular market. Examples include large asset managers whose trading activity is disrupted and investment firms who deal as principal and are therefore the counterparty to consumers (both wholesale and retail), **such as inter-dealer brokers**".*

Furthermore, our concern was heightened when in her launch speech at the FCA launch in June, Margaret Cole singled out the IDB sector erroneously as follows:

[Under the topic of Supervision] *"For both conduct and prudential regulation there is likely to be a small number of firms which will require a more active supervisory programme. This will apply to firms whose failure, even if orderly, could threaten the integrity of particular markets. **One example is inter-dealer brokers.**"*

As stated in the comments to Box 1 above, WMBA members do not deal with any retail "consumers" and hence to associate interdealer brokers with the purely retail activities of asset managers and retail investments firm is inaccurate and misleading for the following reasons:

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- Trading is conducted on an 'arms length' basis with counterparties who do not rely on the advice of the broker. Typically, counterparties in these markets would be wholesale market participants consisting of clearing and investment banks, investment firms, building societies, pension, public sector bodies, life and hedge funds etc and would not include any retail clients as defined under the FSA rules;
- Whilst it is correct to say that IDBs act in a principal capacity (*only when dealing as a matched principal rather than in arranging a named give up trade*), they do not instigate any order flows. Trades are only executed once two clients' interest have been matched and, hence, whilst they are subject to limited counterparty risk unlike the other investment firms mentioned, they are not subject to any market risk. Furthermore, in its capacity as broker, the IDB does not at any point hold client money or take control of any principal in the transaction except for the very limited case of matched principal trades¹. They are classified as **Limited Licence** (and/or) **Limited Activity Firms under CRD** and as such do not instigate trades or hold any proprietary positions.

Further details of the IDBs broking models can be found at: www.wmba.org.uk/executionpolicy/annex2.

Chapter 5 - Paragraph 5.13 Lessons from the Past

5.2 WMBA concurs with the FCA that "*early identification of potential problems in the markets is important*". However, it would like to point out that all the examples quoted in the consultation paper relate to the direct relationship between firms and their retail clients and were in no way caused by, or as a result of, wholesale market activity. Hence, WMBA would once again stress that any future regulation should be geared to the risks involve and a suitably proportionate approach relative to their identified risks, be afforded to firms dealing purely in the wholesale markets.

Chapter 5 – Paragraph 5.24 Wholesale Conduct

5.3 WMBA agrees with the concept that "*wholesale conduct can have implications, including systemic consequences, beyond the confines of the transactions or market in which it takes place and supports the FCA approach of taking greater regulatory interest into whether various wholesale markets have the potential to damage the interests of consumers and the wider economy*". However, as stated previously, they would respectfully draw the FCA's attention to the HMT observation that, "*there are wholesale and market activities which do not directly form part of the transaction chain of products and services sold to retail customers. The scale and importance of these activities make it imperative that they are effectively and proportionately regulated in a way which recognises the particular characteristics of participants in these markets*".

5.4 The primary function of a WMBA member is to act as an intermediary through which other wholesale market participants can conclude transactions by the matching of their trading needs with third party wholesale market participants having reciprocal interests. They are classified as **Limited Licence** (and/or) **Limited Activity Firms under CRD** and as such do not instigate trades or hold any proprietary positions.

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5.5 The WMBA are of the opinion that as Limited Licence (and/or) Limited Activity Firms under CRD, their members fall within the HMT definition of firms “*which do not directly¹ form part of the transaction chain of products and services sold to retail clients*” and, based on a proportionate approach, should be subject to reduced levels of supervision. As stated previously, the WMBA considers that a separate regulatory regime needs to be established for intermediaries dealing purely in the wholesale markets.

Chapter 5 - Paragraph 5.3 Policy & Rulemaking

5.6 With regard to the section on policy/rule-making, the WMBA generally supports the expressions of policy that will govern FCA’s conduct in this area, including:

- (a) early and rigorous market analysis;
- (b) the need to promote competition;
- (c) recognition of the importance of commercial drivers;
- (d) maintenance of strong, traditional disciplines;
- (e) taking into account the principles of good regulation;
- (f) the assurance that the FCA will be “open, listening, consultative and sensitive to the impact its conduct policy will have on the market” (Para 5.33);
- (g) HM Treasury’s assurance in its consultation Cm8083, that it will look to the FCA to strengthen the regulatory system “by promoting the role of judgement and expertise” (Para 1.13); and
- (h) the observation by Hector Sants, Chief Executive, FSA, in his speech to the British Bankers Association on 7th March 2011, in which he stated that “*The FCA will not be a ‘no failure’ institution. Removing all risk-taking from consumers would remove individual freedom of choice and considerable benefits to society.*”

Additionally, the FCA should, in its approach to policy/rule-making, provide specifically for periodic rulebook reviews to avoid unnecessary rules’ duplication and delivery of the Government’s objectives of “value for money” and proportionate regulation.

Chapter 5 - Paragraph 5.4 Consumer Redress

5.7 The WMBA note here that whilst there needs to be suitable provision for retail and customer redress, the wide definition of consumer to encapsulate all the wholesale market participants may leave the FCA being locked into a series of potentially costly, protracted and controversial procedures and processes without good cause.

¹ In the very limited case of matched principal trades, the IDB may briefly hold client money by default should a dividend be paid during the transaction. IDBs do not hold themselves out as providing client money services.

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Information on the Associations

Operating as the hub of the global financial market infrastructure, Interdealer Brokers (IDBs) are MiFID compliant and highly regulated intermediaries by virtue of their regulatory authorisation and from being subject to supervision under CRD as Limited Activity firms. Our members are neutral, independent, and multi-lateral and provide free, fair and open access to their trading venues for all suitably authorised and regulated market participants. IDBs do not take positions in the markets they operate in and their collective service as the gateway to the global financial marketplace creates price discovery and significant liquidity. All transactions, whether executed via voice, hybrid or fully electronic means, are immediately captured at the point of trade, are subject to straight-through-processing, and are made available for transparent and timely transaction reporting to the relevant regulators.

The WMBA have restricted their comments to the topics that are relevant to their members and hence on which they have the relevant experience

WMBA Members:

- BGC Partners
- GFI Group Inc.
- ICAP plc
- Martin Brokers (UK) Ltd
- Reuters Transaction Services Ltd
- Sterling International Brokers Ltd
- Tradition (UK) Ltd
- Tullett Prebon plc
- Vantage Capital Markets LLP

LEBA Members:

- Evolution Markets Ltd
- GFI Group, Inc
- ICAP Energy Ltd
- PVM Oil Associates Ltd
- Spectron Group Ltd
- Tradition Financial Services Ltd
- Tullett Prebon Energy Ltd