WMBA and LEBA Response to the Fair and Effective Markets Review

Key messages:

- *A prime impediment to fair markets has been poor conduct by some market participants and their firms, ranging from attempted manipulation of benchmarks and rate fixings in the wholesale markets to mis-selling in the retail sector. This is a direct consequence of misaligned incentives, abundant capital and integrated business roles that have caused a loss of accountability and the demise of peer review. Authorities have, or are in the process of, introducing reforms and new regulations to reduce or eliminate poor conduct and these should become embedded in markets and firms before further regulatory changes are made.*
- *Efficient markets require certainty, risk, transparency, liquidity, and innovation. There is evidence that liquidity in many markets has diminished as market participants (market makers sell and buy side firms) have withdrawn or reduced their activity as a result of the roll out of some regulation and regulatory uncertainty. These are unintended consequences but may have the effect of reducing market efficiencies.*
- *Encouraging fair and efficient markets is part of the reform process resulting from the 2008/9 financial crisis and the G20 Leaders Statement at the Pittsburgh Summit in 2009. There are 3 key elements of delivering the outcome: reviewing capital and liquidity ratios, including addressing 'too big to fail'; ensuring better conduct and bringing it into a legal framework; and improving market infrastructure. The first is best led by Central Banks, the second by regulators and the third by the private sector in response to regulatory change. Growth and trade are now predominant in the current G20 agenda which therefore promotes the goals of the WTO.*
- *Markets serve trade, and trade is global. Therefore, the most pressing need is to establish globally agreed standards of conduct and market practice which can be seamlessly implemented by firms and supervised by regulators. The rapid development of financial markets and innovation in recent decades resulted in an emphasis on rules rather than principles, and at the expense of observing long standing codes of conduct. A correct balance between rules and codes of conduct needs to be re-established.*

The Wholesale Markets Brokers' Association (WMBA) and the London Energy Brokers' Association (LEBA) (jointly referred to in this document as 'WMBA') are the European industry associations for the wholesale intermediation of organised venue and Over-the-Counter (OTC) markets in financial, energy, commodity and emissions markets and their traded derivatives. Our members act solely as intermediaries in wholesale financial markets and do not undertake any proprietary trading. As a result they are classified as Limited Activity and Limited Licence under BIPRU and IFPRU in the UK where they carry out the vast majority of their activities regardless of home domicile of the individual holding companies. Their two trade associations are set up as 'clubs' in common with many such, and they own two Limited Companies which act in the role of traded index collectors, collators and publishers.

WMBA and LEBA Response to the Fair and Effective Markets Review

WMBA is fully supportive of FEMR's objective of ensuring fair and efficient markets, most especially by introducing standards that contribute to the certainty of standards and professionalism by endorsing market wide codes of conduct. Indeed, WMBA members have witnessed at first hand the declining volume and market participation across all wholesale markets in the period since the financial crisis in 2008. In respect of our reply, WMBA notes that this follows our reply to the associated FEMR benchmarks consultation in October 2014.

WMBA would caution the FEMR secretariat that a reflex urge to regulate has been a common reaction from authorities over generations, yet those environments more highly regulated are not always by definition more safe and therefore 'less risky' than those with professionalism, peer review and established conventions. We believe these are usually better embedded in international '*codes of conduct'* and severely doubt the efficacy of national law on global market places. As a matter of daily commerce, WMBA members do trust in the ongoing professionalism across the FICC community and would note that in the face of the problems which have challenged the markets since 2008, they have still functioned well both in terms of price discovery and post trade settlement.

WMBA welcomes the elevated importance that the Consultation Document places on the behaviour and ethical conduct of individual market participants. While we are of the opinion that the FICC markets enjoy a fundamentally sound structure, recent incidences of market abuse and conduct risk by a minority of market participants have brought disrepute upon the industry, as well as further damaging the overall trust the industry had with the public. Therefore, the FEMR Consultation Document reflects the need for cultural change and that individual behaviour is to be held to the highest standards of ethical conduct. In this context, we would propose that the ACI FMA Model Code provides currently the most comprehensive global best practices and guidelines.

WMBA endorses the recent FCA statement that culture is an essential organisational focus and therefore the key drivers are:

- Setting the tone from the top;
- Translating this into easily understood business practices; and
- Supporting the right behaviours through performance management, employee development, and reinforcing through reward programmes

To achieve this, the industry must promote the cultural paradigm change by:

- Initiating a business wide directive to develop and encourage a culture of trust and empowerment that rewards employees who apply judgment, empathy and insight to actively deliver these outcomes;
- Operate an ethical and responsible customer-centric business with integrity and accountability at all levels;
- Put a front office control framework with protocols and procedures in place, including education programmes, personal development and evaluation measurement and the commitment to an individually accountable, global code of conduct so that this cultural conviction is not disregarded in either the process of business execution or future planning;

- Align business strategy and outcomes to this new model

LEBA would hold up the EU power and gas markets as a clear example of 'better markets' and how beneficial an open access and fungible product architecture can be. We would advocate the FEMR secretariat to examine and advocate a market place that uses open access and utility trading software (Trayport) and post trade architectures (EFET.net) to embrace physical and derivative liquidity pools, both OTC and as designated contracts on RM's conjointly and in a fungible manner to facilitate maximum choice and liquidity to market participants.

The gas and power markets operate through transparent hybrid trading venues which provide real time price and volume information pre and post trade. The wholesale energy markets are also subject to the trade and order reporting obligations under REMIT (Regulation No 1227/2011) which are designed to improve their integrity and transparency and to encourage open and fair competition for the benefit of consumers. REMIT also imposes rules in respect of insider dealing, market manipulation and registration of market participants.

Due to the predominantly bilateral nature of the energy markets, trades are concluded on a name give-up basis whereby the identity of the counterparty on the other side of the trade is revealed to each of the counterparties post execution. Although the identity of the counterparties is not revealed to the rest of the market, details of the transaction (including price, volume and contract tenor) are published publicly. Pre-trade credit checks operated and maintained by trading venues ensure that market participants are able effectively to manage counterparty credit risk.

Answers to specific questions:

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?

WMBA would note the underlying requirement for markets to evolve and innovate to remain fair and effective over time. Consequently, it remains paramount that markets are owned by their participants and serve them in an appropriate and effective manner which cannot be externally prescribed. Therefore, the imposition of market structure, protocols and the forced payment of economic rents through the conferral of intellectual property rights directly leads to misaligned incentives and poor behaviours. This evolution takes place over time, but in open competition, and investment in technology or trading regimes must retain a risk/reward element to be effective. Mandated or imposed changes bring unwanted and unforeseen consequences. The concept of choice must remain, and we note the current coercion of liquidity from principal to agent may be disproportionate where the majority of clients are prepared to pay a spread to execute their business, understanding full well that the bank providing the price-making is taking a proprietary risk in so doing.

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?

WMBA note that six themes can be put into priority sequence as follows in regards to the factors contributing to the recent series of FICC attempted market abuses (with highest contributor first):

1. Responsibilities and incentives
2. Competition and market discipline
3. Standards of market practice
4. Surveillance and penalties
5. Benchmarks
6. Market microstructure

To achieve the necessary degree of accountability and professionalism, it is the responsibility of those providing the incentives over an appropriate period of time, including the individual, line managers, senior managers and the Board of Directors, to ensure that all levels within the company are behaving responsibly, and that the roles of all levels within the company are ensuring the incentives are in alignment with fair market practice.

Most of the standards of market practice across all the market sectors have been broadly appropriate over many decades, and most of the individuals were operating on what they believed to be the right practice for the time. Where this has fallen short, which has been witnessed in the years following 2003, it would appear to us to be due to the increasing role of agency over principal and the consequent demise of ongoing peer review (surveillance). This may be ascribed principally to an abundance of cheap capital (and therefore an absence of penalties) removing the values of the ownership of balance sheet and reliance of reciprocity.

We also note that most of the conduct issues have derived from too much competition rather than too little, resulting in the migration of conduct to the margin in order to effect sufficient or 'normal' returns. Again, this surfeit of competition can be largely ascribed to the abundance of available capital and the relative demise therefore of consequences or deterrents. It is clear here that behaviour moved away from commonly accepted and peer reviewed norms to explore the legal perimeters which had not hitherto been feasible nor desirable.

The changes of market microstructure to facilitate agency and anonymity have been complicit in accommodating a decline in professionalism. Open access in place of supervised dealer groups has led to the bypassing of accepted protocols and the removal of accountability.

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?

Given prudential awareness and management of potential conflicts, the WMBA does not believe that binary options pose risks to the fairness and effectiveness of any FICC markets. Market stakeholders and participants live with binary business risks and therefore have legitimate hedging needs to match these. Like many OTC products, binary options developed as a result of the demand from *firms wishing to hedge FX (and other) exposures* as an alternative, or in addition, to 'vanilla' options. These options are typically written by banks which earn revenues from providing the hedging tool and then manage their exposure according to their internal positions and limits. The options can also be used to create risk positions for trading or investment purposes, but their origin is in the need for a risk transfer product, and they are intended for professional use. The mechanism of buying, writing and managing options is an important part of creating *effective markets* for sophisticated financial products.

The management and expiry of barrier and digital options could lead to *potential conflicts* of interest between the buyer and the writer of the option, especially during times of stressed volatility and poor market liquidity, as described in the CP. It has long been recognised that sophisticated products offered by banks to their (professional) clients should be subject to rigorous suitability checks which must ascertain whether the client fully understands the mechanics of the trade as well as the ongoing risk management of them. *Suitability* remains the cornerstone of ensuring that the client is *treated fairly* and that conflicts are transparent and declared.

Banks' internal processes require *constant monitoring of positions*, valuation and the expiry calendar by independent units within the bank. These processes should be subject to compliance, financial control and audit checks which can be observed by supervisors and *regulators*.

Whilst users of such hedging products should not be expected to have the same risk management and monitoring tools as those used by banks, relationship management teams at banks should ensure that the client is informed about the value of their hedge and the its exposure to market conditions. This *minimises the risk of conflict* by keeping the client informed and that the options bought are *both fair and effective*.

Q4: Does the market microstructure of specific FICC markets — including trading structures, transparency, and asset heterogeneity or market access — enhance or diminish fairness and effectiveness? Where there are deficiencies, will recent or in-train regulatory or technological changes improve the situation,

or are further steps needed? How do these answers vary across jurisdictions, or specific markets within FICC?

Developments in FICC market infrastructure are a function of technological advances and investment, competition amongst providers, client demand and regulatory change. Recently, and in particular since the *G20 meeting in Pittsburgh in 2009*, all of these forces have improved pre and post trade transparency and are reducing risk by the promotion of the use of netting and clearing.

Initiatives in the EU through the rollout of MiFID II and EMIR and Dodd-Frank in the US should be considered as *work in progress* to improve market infrastructure and make markets less exposed to large systemic shocks. It is essential that global coordination takes place *through the FSB, Basel and IOSCO in order to minimise the risk of regulatory arbitrage*. This is particularly the case in respect of rules on capital (including leverage), liquidity and resolution and recovery where buy in to the Basel Accord globally would significantly reduce the risk of regional arbitrage.

The financial crisis of 2007-09 and the subsequent discovery of poor risk management and bad conduct and behaviour triggered the measures mentioned above, and significant changes have been made to banks internal processes, controls and compliance management. There are *3 key elements of market microstructure* being addressed:

- Changes in rules on *capital and liquidity* through the migration of Basel II to Basel III. This work should be agreed between regulators and Central Banks on a global basis with national authorities being allowed to use the rules to fit their own financial and broader economic infrastructure and characteristics;
- *Conduct and behaviour* of institutions and individuals is becoming subject to much stricter rules and enforcement. This should continue to be the remit of national regulators taking into account consumer interests and existing laws; and
- Increasing use of *trading platforms and technology* to improve pre and post trade transparency and enable better risk management. Technology vendors, competition between market participants and client demand are the driving forces behind the improvements being seen.

Regulators and supervisors should focus on the first 2 of these issues, leaving market participants to deliver the platforms and technology required to meet supervisory and regulatory change.

These changes in market microstructure are also *changing financial institutions business models.* In particular, banks have reduced their market making capabilities in response to rules concerning proprietary trading and the capital and liquidity costs of maintaining positions. As regulators and firms continue to address the issue of serious misconduct, bank trading rooms are adjusting by very rigorous surveillance of trading activity which often requires judgements to be made about the risk reward benefits of entering into a specific trade. This is having a negative impact on liquidity as the incentive to trade is impaired.

In response, banks are acting increasingly as *agents rather than principals* in FICC markets. The respective roles of principal (dealer) and agent are clearly different and there may be some confusion as business models change. This is thus a *potential conflict* between *'fairness'*, being delivered by better conduct, and 'effectiveness' as markets experience lower liquidity and market making capacity as the regulatory environment adjusts to the new rules.

Q5: Is greater use of electronic trading venues for a wider range of market participants possible or desirable? Are there barriers preventing a shift to a more transparent market structure?

Whilst WMBA are proponents and operators of a great many electronic trading venues around the globe, including most SEFs in the US and non-equity MTFs in the EU, it is not clear to us that more electronic trading is a holistic target for the wider communities and participants which these markets serve. We would caution the linked use of the term transparency and latency since FICC markets are more reliant on matching volume (size) rather than price. The recent price action in FX and execution of 'Stop-loss orders' post the SNB removal of the EUR/CHF peg provides a convenient example.

We note that the decline in accountability and conduct standards have closely paralleled the growth of both electronic markets and agency execution. Further, the traits of fragmented order size, latency arbitrage and layered anonymity do not harmonise with the desired outcomes of certainty, liquidity, capital commitment, reciprocity and trust. We underline that in times of uncertainty and volatility the markets have returned to voice time and time again. Therefore, we would caution the implicit assumptions made by the FEMR authors in the format of question 5.

Q6: Is standardisation of corporate bond issuance possible or desirable? Should standardisation be contemplated across a broader range of fixed income products? How that could be brought about?

Whilst WMBA firmly advocate the standardisation of legal terms, conduct and post trade processes, we understand that prescribing product standardisation beyond the appetite of market participants simply confers basis and mismatch risks to end users. In the case of corporate bonds, moving towards electronic and benchmark liquidity simply increases the costs of issuance and reduces the returns to investors. Rather, new issuance should be encouraged where it is most efficient and in demand across the scope of tenors, currencies and products. This in turn provides a richer and more diverse environment for investors with markedly reduced pass-through risk of contagion.

Q7: Should the new issue process for bonds be made more transparent through the use of auction mechanisms, publication of allocations or some other route?

Auction mechanisms are already available should they be desired, but are not always employed. The WMBA appreciates the role of capital commitments and syndication and would endorse the availability of suitable choice for issuers.

Q 8: Are there risks associated with internalisation and last look practices? Are there barriers preventing increased pre and post-trade transparency in foreign exchange markets?

Internalisation is the practice of matching trades and orders within the position books and on the balance sheet of the principal or dealer bank. This leads to *efficiencies in order execution,* better risk management control and lower costs because of the significant reduction in execution costs. Internalisation thus facilitates deeper liquidity and tighter spreads to the benefit of the user.

The proliferation of electronic platforms, the advances in technology and software quality has enabled banks to internalise more efficiently and provide more services to their clients who also have access to more execution platforms.

Banks, particularly those offering an agency service, must meet best execution requirements as they will be acting as systematic internalisers under MiFID II. Banks should disclose how orders are managed and offer appropriate transparency, particularly when handling stop/loss or limit orders.

It should be noted that *internalisation works best for liquid and simple products (like FX*) and that less liquid currency pairs and OTC products can give rise to reduced transparency and execution capacity. Banks should keep careful, comprehensive and timely records to enhance the fairness and reporting of transactions.

'Last look' is the practice of market makers rejecting a trade on a price that it has made after a very short time of receiving an order. They may do this because of credit limit reasons or operational risk events resulting from latency or timing differences. Last look does facilitate narrower spreads between bid and offer rates and permits better risk management for the market maker.

'Last look' can be used unfairly to the disadvantage of clients and counterparties when market makers stand aside from trading on a bid or offer that they have made with the intention of price discovery rather than market making, or rejecting trades that they can only close out with a loss.

Although improvements in technology and the reduction in latency of price dissemination reduce the opportunity for misuse of 'last look', tensions still persist between market makers and counterparties. WMBA believes that these can be significantly reduced by the use of agreed *Market Standards and Codes of Conduct* as laid out in the CP. These would be evidenced in the exchange of documentation making the market fairer for the client whilst encouraging efficiencies in market making and providing narrower spreads for the Dealer bank.

Q9: Are there barriers impeding the development of more comprehensive netting and execution facilities for transacting foreign exchange fix orders?

WMBA is entirely supportive of the *recommendations of the FSB FXBG* and the identification of Critical Benchmarks following the recent consultation. Since the launch of Continuously Linked Settlement (CLS), the *industry has led innovation designed to improve netting and reducing settlement risks* and market participants should be encouraged to develop further tools.

A global utility to net fixing orders would require a Central Bank led initiative which would need risk taking and risk management capacity as well as regulatory oversight. It is not clear that this is achievable or would be cost effective, and in the meantime existing fixing methods are being refined to increase transparency and reduce the scope for manipulation.

Regulators should ensure that the supervision of critical benchmarks is done in a way that reflects the nature of the underlying product and the way in which the benchmark is calculated. The objective should be to eliminate the scope for manipulation without creating unnecessary infrastructure or costs which would handicap the incentive to create or use the benchmark.

Q10: Are there any material barriers preventing greater transparency in OTC commodity derivatives markets? If so, what could be done to remove them?

The London Energy Brokers' Association (LEBA) notes that commodity and commodity derivative markets are extremely diverse on all parameters and therefore cannot be commented upon collectively in the round. One overarching barrier however, which has prevented effectiveness and efficient price formation across many commodity markets, is, of course, the persistent politicisation of these markets. In particular, commodity derivatives have been segregated from the underlying physical and forward markets by a series of measures including market structure, position limits and the capital treatment of market participants. It is important that liquidity is recognised and treated as a valuable resource for market participants and the utility of the forward and derivative curves are reunited with prompt market liquidity. One urgent measure here is the adoption of an adequate definition of a derivative combined with the recognition that forward delivery contracts are themselves not derivatives.

LEBA would commend to the FEMR secretariat the recent commentary of Dieter Helm of Energy Futures Network regarding the perpetual political compromise of energy markets (The road to re-regulation Dieter Helm; EFN Paper No. 7). Similarly, commodity prices have been widely and unfairly blamed by politicians, both in the EU and the US, on the segregated supply and demand curve intersections of the derivative markets as opposed to the physical markets. Clearly, the derivative markets net to zero yet they still provide a convenient scapegoat until prices fall.

There are a great many barriers preventing greater transparency in OTC commodity derivatives markets arising from the proliferation of intellectual property rights across many of these markets where post trade infrastructures are difficult to access. It is likely that only the construction of utility infrastructures for the storage, nomination and delivery of such would encourage more competitive market places.

Conversely, LEBA would hold up the EU power and gas markets as a clear example of 'better markets' and how beneficial an open access and fungible product architecture can be. We would advocate the FEMR secretariat to examine and advocate a market place that uses open access and utility trading software (Trayport) and post trade architectures (EFET.net) to embrace physical and derivative liquidity pools, both OTC and as designated contracts on RM's conjointly and in a fungible manner to facilitate maximum choice and liquidity to market participants. We would be happy to provide more details on request.

The gas and power markets operate through transparent hybrid trading venues which provide real time price and volume information pre and post trade. The wholesale energy markets are also subject to the trade and order reporting obligations under REMIT (Regulation No 1227/2011) which are designed to improve their integrity and transparency and to encourage open and fair competition for the benefit of consumers. REMIT also imposes rules in respect of insider dealing, market manipulation and registration of market participants.

Due to the predominantly bilateral nature of the energy markets, trades are concluded on a name give-up basis whereby the identity of the counterparty on the other side of the trade is revealed to each of the counterparties post execution. Although the identity of the counterparties is not revealed to the rest of the market, details of the transaction (including price, volume and contract tenor) are published publicly. Pre-trade credit checks operated and maintained by trading venues ensure that market participants are able effectively to manage counterparty credit risk.

Fundamental to our point about the fallacy of central planning for market structure, these model markets weren't designed to be the way they are but the result of lucky accidents. This underlines the need to embrace and promote Darwinism and Schumpeter in financial market structure. It may be argued that platforms employing Trayport software enjoy a near monopoly in the OTC energy markets and that this software should be on an open source architecture. Yet the point remains that anyone can join that set of market operators and anyone can join the set of market participants, with the resultant transactions and risk being fungible and interoperable. It is widely agreed that common protocols added to ongoing competition does actually work well in these markets, that's because the software is very inclusive, very flexible and able to adapt to the changing requirements of all stakeholders.

In the post-trade environment across these same energy markets, EFET.net has also got a near monopoly, but it is something of a unique animal in that its development was funded by a group of market participants in a philanthropic way. So it therefore functions as a non-profit making organisation in a manner analogous to the DTCC. It works well because it employs open source software, its flexible, seeks no intellectual property rental and was built by the industry, with the involvement of the industry exclusively for the industry.

Q11: Are there any areas of FICC markets where regulatory measures or internationally co-ordinated regulatory action are necessary to address fundamental structural problems that exist?

As mentioned in our answer to Q4 (above), there are 3 areas of regulatory focus being implemented on a global basis: Basel III for changes to capital, liquidity and resolution regimes; changes in national laws to improve conduct and punish bad behaviour; and regulation designed to improve the market infrastructure. All of these changes are underway and in the process of being implemented or agreed in detail.

It is WMBA's view that *further regulation should not be considered until the effects of these changes can be judged*. It also believes that the industry is best placed to improve efficiencies and fairness through the development of platforms and technology, and that the mandating of venues is not optimal. Regulatory resource should be used to achieve the objectives of protecting the consumer through national regulation, and the economic welfare of economies with significant financial markets through the application of the Basel Accord.

Regulatory initiatives in respect of venues have already led to *arbitrage and the bifurcation of liquidity to the detriment of markets and their efficiencies*. These are clearly unintended consequences and aligning regulatory understanding and implementation is a necessary condition for the consideration of further regulation.

Conflicts of interest and information flows

Q12: Where do potential conflicts of interest arise in the various FICC markets, and how do they affect the use and potential abuse of confidential information, both within and between firms?

Q13: How can the vulnerabilities posed by such conflicts be reduced? Are existing internal structures and control_procedures sufficient? Where they are not, are further internal management controls required (such as better trading floor design and/or closer monitoring of electronic communications within and between firms) or is more radical action required to remove conflicts altogether?

The potential for conflicts of interest are unlikely to be permanently eliminated and can cause inefficiencies and unfair practices. They can be recognised and managed provided the providers and users of financial products understand where and how they may arise, and financial market participants can demonstrate to regulators that they have suitable systems, controls and mitigation techniques. To achieve this, *existing regulation should be enhanced by the use of standards of best practice and codes of conduct (see Q28-32).*

A clearer understanding of the role and status of participants is required. The spectrum of participants lies between principals and market makers, and retail consumers. In between are degrees of semi and fully professional counterparties, divided further into bank, non-bank financial institutions and non-financial enterprises. It is essential that dealers and principals adopt procedures that distinguish between users consistent with regulation and in order to achieve best execution. In turn, regulation should not blur the lines between users in a way that creates inefficiencies and disincentives to offer financial products to suitable users.

Information flows can be divided broadly into two types:

- *Market information* that is publicly available and that should be made available to all participants and end users. Efficiencies can best be achieved through *competition amongst providers* and the development of technology (web based or bespoke programmes) to be used by providers and end users alike.
- *Confidential information* of a deal specific or proprietary nature, the use of which may damage the interest of client. Current and proposed regulation and the legal framework relating to

market abuse is sufficient control misuse or the illegal use of information. Banks must ensure that they can comply with the regulations, and regulators that they can supervise banks offering the relevant products.

Conflicts can be reduced and managed by relying on the formality and protocols of a code of conduct. Confidentiality is essential for the preservation of a reputable, ethical and honest market place. The ACI Model Code insists that firms must have in place clearly documented policies and procedures, and strong systems and controls, to manage confidential information within the dealing environment and other areas of the firm which may obtain such information. Any breaches to this should be investigated immediately according to a properly documented procedure.

- *Firms with a fiduciary interest in certain trades should disclose this information to the counterparty to avoid or manage any potential conflict of interests;*
- *Dealers should at all times, act in the best interest of their customers and disclose any potential conflict of interests to the customer where necessary;*
- *When disclosure of specific conflicts of interest is required, the disclosure shall clearly state the arrangements that have been established to manage that conflict; and*
- *The description of the conflict of interest must explain the general nature of the conflicts of interest, as well as the risks to the client that might arise as a result of the conflict and the action undertaken to mitigate these risks, in sufficient detail to enable that client to make an informed decision regarding the transaction.*

Q15: To the extent that competition is currently ineffective in any of the FICC markets, are there market-led initiatives, technological or structural changes that may remedy this situation?

Following on from Q.10 above, WMBA/LEBA would firmly advocate the model of the OTC Power and Gas markets in Europe. This combines competition, open access, innovation and a utility post-trade. We emphasise here that the enemy of fair and efficient markets is the reservation of access and application of intellectual property rights. These simultaneously extract an uneconomic tithe rent from market participants whilst stifling innovation and open architectures.

Q16: Are there any lessons that can be drawn from experiences in other financial markets (or indeed other markets) about the ways that alternative or evolving market structures could impact on competition in FICC markets?

The only overarching lesson that can be drawn is that top down impositions of market structure rarely, if ever, have the desired effects whilst almost always arrive with concomitant unintended consequences which are detrimental to the efficacy of the liquidity pool and cost of transactions.

Q17: How effective is market discipline in enforcing sound market practices in each of the key FICC markets? What could be done to strengthen it?

Q18: In what ways might competition in any of the key FICC markets usefully be addressed by competition authorities (e.g. by assessing the state of competition in relevant markets)?

Evidently, both in terms of the reservation of access and application of intellectual property rights, parts of the venue driven FICC markets suffer from an absence of competition. Similarly, the costs of market data are overdue a competition review as recognised by the FCA.

However, with the results of the FCA Wholesale Sector Competition Review 2014 is still outstanding and the WMBA proposes that it would be prudent to await publication of the findings and evaluate their impact before prematurely initiating any additional assessment in the relevant markets.

Q19: Are there any additional regulatory reforms that could be helpful in promoting competition and market discipline in FICC markets?

WMBA asserts that the single most effective measure that could be helpful in promoting competition and market discipline in FICC markets would be the legal mandate for the assertion of interoperability between post trade financial market infrastructures. Under mandated clearing and the effect of differential margin quantum and application, these silos are evidently set to pose a systemic risk. Therefore, the provision of choice and ongoing permanent peer review would be the most effective mitigation to promote both competition and market discipline.

Q20: Is there a need for better awareness and understanding of the existing competition framework among FICC market participants, both at firm and individual level? How do you think that might be best achieved?

WMBA is not clear that this is currently the most urgent priority. Indeed, it may be the erosion of service provision and the inability of the market to effectively offer liquidity and infrastructures such as benchmarks due to margin erosion and high compliance and capital costs that is the more cogent threat to effective FICC markets.

Q 21-26: Benchmarks

WMBA fully endorses, and wishes to refer to, the work done by *the FSB and the IOSCO principles for financial benchmarks* and believes that adherence to the principles should form the *basis for their global regulation*. Benchmark regulation is at a very early stage of development and it will not be clear for some time whether the framework of regulation is sufficient to eliminate misuse or proportionate to the nature of the benchmark. It is essential that regulators work with benchmark providers and end users to ascertain the best way of establishing the credibility of the benchmark and the assurance of its accuracy. The identification of critical benchmarks and the authorisation of regulated Benchmark Administrators have enabled supervision of benchmarks for the first time.

Many issues have been raised in the preparation of regulation of benchmarks and the implementation of the IOSCO principles, principle among them being;

- *Radically changing the way in which submitters of benchmark data organise internal compliance and controls* in order to prevent incorrect quotations or submitting deliberately false transactions. In response to misconduct in Libor and ISDAFix submissions and the behaviour around FX fixings, bank submitters, calculating agents and administrators have significantly changed and improved submission and order management processes as regulators are imposing new regulations. This should be considered as a work in progress which will continue to change benchmark management dramatically. *Further measures are therefore not required at this stage.* Instead, regulators, submitters and administrators should ensure that the IOSCO principles are put into place and agreed in practice between them.

- There has been little debate about *what benchmarks rates are for and* how they are used. Some have their genesis in pricing financial products (e.g. Libor for lending and capital market rate fixing), some for executing transactions (e.g. the Reuters WM FX fix), and others for revaluation of portfolios, risk positions and balance sheet exposures. In some cases, such as SONIA, the underlying transactions play a role in monetary policy. It should further be noted that such rates are not always made use of in public but are also used for internal valuations such as the profit and loss calculations of individual trading desks. This has resulted in an *over reliance on benchmarks* or not understanding what they are for or what their use is appropriate for. Benchmarks, therefore, have different characteristics which should be taken into consideration when assessing the possibility of attempted manipulation and their impact on wider financial markets. WMBA recommends that the FSB engage in a study of benchmark use which may result in further or amended principles.

- *Benchmarks calculation and design* can be divided broadly into 4 categories:

    - Those calculated from surveyed data which may require expert judgement or the use of correlated data (e.g. Libor);
    - Those calculated from prices posted on electronic platforms (e.g. ISDAFix);
    - Those calculated from actual traded data (e.g. SONIA); and
    - Rates derived from a fixing process during a specific trading window (e.g. FX)

    The calculation of each of these benchmarks is very different and subject to various levels of exposure to manipulation and inaccuracies. The *governance procedures* required for different types of benchmark (i.e. oversight and code of conduct) are different, and a tailor-made and proportionate approach needs to be taken when implementing regulation for each of these types of calculation. Failure to do this may result in disincentives to submit data and make the benchmark economically unviable.

- The recent *FCA consultation on critical benchmarks* was welcomed by WMBA because it has prioritised those which have systemic importance. Those identified are all in the financial markets sector (oil futures are a financial product) and it remains to be seen which, and how many, critical benchmarks lie in energy and commodity markets. Many of these have different characteristics to financial products and are calculated in different ways. WMBA strongly recommends that regulators take an incremental approach to identifying further critical benchmarks and ensure that their regulation is proportionate to the importance and calculation methodology of the benchmark, as well as the existing governance structures.

Q 27-33: Market Practice and Codes of Conduct.

WMBA has strongly supported the *Bank of England's NIPS Code and the ACI Model Code* for many years and welcomes the FSB emphasis on how codes of conduct may improve conduct and behaviour among market participants.

Product sets within FICC markets have developed from different backgrounds and have been subject to various forms of regulation and oversight. Some have more OTC characteristics and are less subject to being standardised or capable of being migrated to electronic platforms. Others rely heavily on market makers for liquidity, and there are many forms of derivative attached to the underlying products. As a result, there are numerous best market practices which apply idiosyncratically to product types. A 'one size fits all' approach is therefore unsuitable and impractical.

WMBA believes that there are *4 elements* to incorporate into the wider use of codes of conduct:

- Especially for FICC markets, the codes must be capable of being *used and observed globally*. This means that they should be proposed and led by Central Banks and/or the FSB using trade bodies and other institutions to advise, promote and recommend on the implementation of codes in individual markets and firms;
- High level principles should focus on *individual conduct and behaviour* and the way in which firms can use codes to incentivise good conduct and punish bad conduct. The fundamental target should be individual integrity;
- *Standards and best practice* which apply to specific markets or products, and which there is a general agreement to adhere to; and
- *Market conventions* relating to specific incidents or market events.

The inherent conflict between rules and codes is acknowledged by WMBA. It is to be noted that adherence to codes of conduct was more prevalent as markets were developing in the 1960's, 70's and 80's and that financial firms rather than regulators used the codes to ensure good behaviour among employees. As markets became more sophisticated, codes migrated into rules which were imposed by regulators and assured by compliance and legal functions in individual firms. The ability of firms to influence behaviour by the use of codes thus became blunted.

WMBA believes that the *application of codes of conduct* at individual level can be used to overlay principles and rules to target good behaviour in a more focussed way. This *requires:*

- *Individual firms to insist on staff adhering to the firm's own code* and a code, or codes, of conduct generally accepted by the market for the relevant FICC product. Individuals can be incentivised or punished through HR practices including appraisals, promotion opportunities, and remuneration. Firms must demonstrate to supervisors how they apply codes of conduct;
- *Regulators must be able to observe, incentivise and punish firms* for their ability to implement a code of conduct or unwillingness to do so. This can be achieved through further guidance on *Pillar 2 of the Basel Accord* (and CRD IV), which would incorporate the use of codes into risk management assessment;
- *Education and training in codes* must be offered by firms from accredited sources. As markets are dynamic, such training should be on a CPD basis. Whether or not training in codes should be mandated should be the remit of the firm and their regulators, and be taken into account favourably in Pillar 2. The mandating of a code of conduct exam should be subject to international agreement or by regulators in individual markets.

WMBA supports the ongoing work being done by the FSB and believes, at this stage, that codes of conduct should be the remit of the central banks underpinned by specific and global codes such as the ACI Model Code for different product sets.

Q34: In the context of implementing MiFID 2, which of the FCA Principles for Businesses should apply in relation to MiFID business with Eligible Counterparties?

Q35: Are there any financial instruments that should be brought more fully into the scope of regulation in order to improve the fairness and effectiveness of specific FICC markets? For any instruments proposed: (a) what protections does the current framework provide; (b) what gaps remain of relevance to fairness and effectiveness; and (c) what is the cost/benefit case, bearing in mind the Review's Terms of Reference as set out in Section 1? 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?

Firm-wide initiatives to improve incentives and governance

Q37: Do respondents' agree that the thematic areas highlighted in Section 5.5 are key priorities for FICC firms (fine-tuning performance measures; adjustments to remuneration; attitudes towards hiring, promotion and advancement; closer board involvement in governance of FICC activities; and clearer front line responsibilities)?

What specific solutions to these challenges have worked well, or could work well? And how best can the authorities help to support these initiatives? Market wide initiatives to align market conduct, incentives and governance

Q38: To what extent could the Banking Standards Review Council help FICC market participants to raise standards collectively — in particular, are there other steps that could be taken to help complement or extend this initiative in FICC markets for non-banks and internationally?

Regulatory initiatives to improve governance and incentives

Q39: Are there other regulatory measures the authorities could take to strengthen personal accountability or otherwise improve the way firms manage incentives and governance? In particular, should any or all of the measures in the Senior Managers and Certification regime be extended to non-bank firms active in FICC markets?

Surveillance and penalties

Q40: What role can more effective surveillance and penalties for wrongdoing play in improving the fairness and effectiveness of FICC markets globally? How can firms and the industry as a whole step up their efforts in this area? And are there areas where regulatory supervision, surveillance or enforcement in FICC markets could be further strengthened?

Firm level surveillance

Q41: How can firms increase the effectiveness of their own surveillance efforts across FICC markets globally? What role could the industry play in helping to explore best practices on how to make whistle blowing and other similar regimes more effective? Is there scope to make greater use of large scale market data sets and electronic voice surveillance to help detect cases of abuse in FICC markets?

Are there other potentially effective tools?

Firm level penalties

Q42: Are there processes or structures that can allow firms to punish malpractice by their own staff more effectively (for example, penalties for breaching internal guidelines)?

Q43: Could firm’s active in FICC markets do more to punish malpractice by other firms, for example by shifting business and reporting such behaviour to the authorities?

Regulatory level surveillance and supervision

Q44: Is the current supervisory approach and level of intensity dedicated to supervising conduct within the UK wholesale FICC markets appropriate?

Q45: Are there ways to improve the data on FICC market trading behaviour available to the FCA, whether through the extension of the regulatory perimeter or otherwise?

Regulatory-level penalties

Q46: What further steps could regulators take to enhance the impact of enforcement action in FICC markets?

Q47: Should consideration be given to greater use of early intervention, for example, temporary suspension of permission for a particular trading activity for firms or individuals or increased capital charges?

Q48: Is there a need to widen and or strengthen criminal sanctions for misconduct in FICC markets?

Q49: Is the approach set out in the Criminal Sanctions Market Abuse Directive appropriate for the United Kingdom? Are there additional instruments or activities to those envisaged by the Directive that should be covered by the domestic criminal?

If you would like any further information/clarification in respect of these issues, please do not hesitate to contact the persons named below. WMBA are happy for these comments to be disclosed.

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