



The UK's Fair and Effective Markets Review

Introduction

On 10 June 2015, the Bank of England (“BoE”), HM Treasury (“HMT”) and the Financial Conduct Authority (“FCA”) published the final report on the “Fair and Effective Markets Review” which had been launched one year ago with the aim of reinforcing confidence in the wholesale fixed income, currency and commodity (“FICC”) markets. During this period, a wide consultation was carried out with many entities and organisations, including some based outside the UK.

The report provides an analysis of the causes of recent market misconduct and other sources of perceived unfairness in FICC markets and evaluates the impact of reforms already in force or underway. It sets out 21 recommendations for further work and action.

The report states that its recommendations are shaped around the following key principles:

- individuals active in FICC markets should be more accountable for their actions;
- firms active in FICC markets should take greater collective responsibility for developing and adhering to clear, widely understood and practical standards of market practice, in regular dialogue with the authorities;
- the UK authorities should extend the regulatory perimeter, broaden the regime holding senior management to account and toughen sanctions against misconduct;
- international authorities should collaborate to raise standards in global FICC markets;
- market participants and authorities should work together in the years ahead to (i) promote fairer FICC market structures while also enhancing effectiveness and (ii) ensure a more forward-looking approach to the identification and mitigation of conduct risks.

Policy Recommendations

The recommendations are divided between near-term actions to improve conduct in FICC markets and principles to guide a more forward-looking approach to such markets.

Recommended Near-Term Actions

1. *Raise standards, professionalism and accountability of individuals*

- (a) Develop a set of globally-endorsed common standards for trading practices in FICC markets, in language that can be readily understood and which will be consistently upheld. The Review is not prescriptive as to what these standards should contain but suggests there should be a balance between high-level principles and more detailed rules.
- (b) Establish new expectations for training and qualifications standards for FICC market personnel, with a requirement for continuing professional development. The Review contains a blueprint for a possible framework in this regard.
- (c) Mandate detailed regulatory references to help firms prevent the “recycling” of individuals with poor conduct records between firms. This is referred to as the “rolling bad apple” issue in the Review, and it is noted that firms report that it has become increasingly difficult to obtain information on individuals’ conduct records from previous employees through the use of employment references. The Review states that, following the implementation of the Senior Managers and Certification Regimes in the UK, the FCA will continue to maintain a public register of individuals subject to prohibitions, and there will be requirements for regulated firms to notify the regulators of an actual or suspected breach of relevant rules. It also considers that there is a strong case for authorities to mandate a form setting out in detail the minimum information that firms should include in regulatory references and providing that firms should not be allowed to use non-disclosure agreements with departing employees to limit the disclosure of information in such references.
- (d) Extend UK criminal sanctions for market abuse for individuals and firms to a wider range of FICC instruments. The Review notes that, under the current UK regime, individuals involved in market abuse can still target instruments that fall outside the scope of criminal sanctions in the UK. Also, although the existing regime applies criminal liability to firms in relation to market manipulation, it does not apply criminal liability to firms in relation to insider dealing. The Review recommends that the regime should be extended to apply criminal liability to firms for both market manipulation and insider dealing. It also states that the Ministry of Justice has been examining the case for a new statutory offence of “corporate failure to prevent economic crime”. The Review suggests that HMT considers whether further changes to corporate criminal liability for market abuse offences are appropriate and desirable.
- (e) Lengthen the maximum sentence for criminal market abuse from seven to ten years’ imprisonment.

2. *Improve the quality, clarity and market-wide understanding of FICC trading practices*

Create a new FICC Market Standards Board with participation from a broad cross-section of global and domestic firms and end-users at the most senior levels, and involving regular dialogue with the authorities, to:

- scan the horizon and report on emerging risks where market standards could be strengthened, ensuring a timely response to new trends and threats;
- address areas of uncertainty in specific trading practices, by producing guidelines, practical case studies and other materials depending on the regulatory status of each market;
- promote adherence to standards, including by sharing and promoting good practices on control and governance structures around FICC business lines; and
- contribute to international convergence of standards.

The Review believes that this new Board should be established initially in the UK but should aim to have international reach through its private sector membership and should, over time, seek opportunities to work with similar organisations and authorities in other jurisdictions. It believes the membership should be significantly broader than the existing UK Banking Standards Board and should include non-banking firms active in FICC markets, including broker-dealers, investment managers and corporate issuers.

The Review also states that the new Board should adhere to a number of principles including that:

- it should maintain a regular dialogue with relevant regulatory authorities and put in place appropriate governance structures to ensure its work programme and the materials it produces take into account relevant regulatory standards and initiatives;
- its membership should comprise a balanced representation of all types of market participants;
- its members should be senior business leaders with extensive experience in FICC markets;
- its members should have sufficient authority to engage their firms' senior management to marshal resources to support the Board's activities, and to muster their institutions' endorsement of proposed recommendations; and
- it should be supported by a high-quality, technically-able secretariat.

3. Strengthen regulation of FICC markets in the United Kingdom

- (a) Extend the UK regulatory framework for benchmarks to cover seven additional major UK FICC benchmarks. This recommendation has already been accepted and implemented by HM Treasury on 1 April 2015. The relevant benchmarks are SONIA (Sterling Overnight Index Average), RONIA (Repurchase Overnight Index Average), LBMA Gold Price, LBMA Silver Price, WM/Reuters London 4pm Closing Spot Rate, ICE Brent Index and the ICE Swap Rate (previously ISDAFIX).
- (b) Create a new statutory civil and criminal market abuse regime for spot foreign exchange (FX), drawing on, among other things, work on a global code. In view of the seriousness of recent misconduct, the Review recommends that globally agreed principles should be used to shape a new statutory market abuse regime for spot FX in the United Kingdom, to maximise protections against market abuse. It notes that the new European Market Abuse Regulation (MAR), which applies from July 2016, does not directly apply to spot FX as an asset class. It believes its objectives can be achieved by the creation of a new standalone legislative regime that could be applied to spot FX and other FICC instruments as necessary.
- (c) Ensure proper market conduct is managed in FICC markets through monitoring compliance with all standards, formal and voluntary, under the Senior Managers and Certification Regimes. Under the Senior Managers and Certification Regimes, regulators will be able to hold individuals to account for conduct failings and require all traders and other relevant individuals to comply with specific conduct rules, and they will be personally accountable for any breach of such rules. The Review believes this will provide helpful teeth to non-statutory market codes and guidelines (e.g., the proposed global FX code referred to below). The Review also sets out a high-level blueprint for FICC market training and qualification standards which it believes will assist in firms meeting the requirement that they ensure that senior managers, certified staff and relevant employees subject to the individual conduct rules have a deep understanding of the practical application of the specific rules which are relevant to their work.
- (d) Extend elements of the Senior Managers and Certification Regimes to a wider range of regulated firms active in FICC markets. The Review believes that the elements to be extended should include regulatory pre-

approval and Statements of Responsibility for senior managers, certification of individuals with the potential to pose significant harm to a firm or its customers and enforceable conduct rules for individuals. The Review states that this recommendation should be subject to consultation including as to the precise scope of the extension and the exact makeup of any new regime. It believes that such extension should apply to authorised firms active in the FICC markets but currently out of scope of the existing regimes (including MiFID investment firms and hedge funds under the Alternative Investment Funds Managers Directive (“AIFMD”)).

- (e) Improve firms’ and traders’ awareness of the application of competition law to FICC markets. The Review notes that collusion can have a highly damaging effect on the integrity of FICC markets, and the work done by the Review indicates some shortcomings in the understanding of the extent and power of competition law, including the fact that competition law covers all market segments and firms, and breaches can have very serious consequences for individuals, including custodial sentences of up to five years.

4. Launch international action to raise standards in global FICC markets

- (a) Agree a single global FX code, providing: principles to govern trading practices and standards for venues, examples and guidelines for behaviours; and tools for promoting adherence. The Review strongly welcomes the recent announcement by central banks to work towards those goals.
- (b) As part of that work, improve the controls and transparency around FX market practices, including “last look” and time stamping. The Review states that, although in many respects FX markets are highly transparent, the proliferation of electronic venues and the growth of non-bank counterparties has created a fragmented market structure increasing complexity. More sophisticated market participants typically use liquidity aggregation technologies and sophisticated order execution strategies to connect to relevant liquidity pools. Pre-trade search costs are likely to be significantly greater for participants who do not have access to such technologies. The Review notes that this issue has been addressed in part by several market participants and third-party service providers offering “transaction cost analysis tools,” but it believes there is scope to improve transparency further in ways that do not affect the effectiveness of FX markets. It believes that there should be greater transparency in relation to information relevant to the execution of orders, and that time stamps showing the point of execution should always be provided. It also believes that the practice of “last look”, i.e., giving market makers a final opportunity to reject an order after a client commits to trade at a quoted price, could be abused by market makers. It therefore recommends that its proposed new international standards process on FX markets should set out clearer standards on “last look,” including whether it should remain an acceptable market practice. The Review also considers the increased use of “internalisation” where market makers match trades across their own books rather than through external brokers. It notes that the lack of transparency in respect of such practice could limit the ability of clients to assess the quality of execution they receive.
- (c) Explore ways to ensure benchmark administrators publish more consistent self-assessments against the IOSCO Principles, and provide guidance for benchmark users. The Review notes that most respondents to its consultation praised the global efforts to reform relevant aspects of benchmark design and oversight, but there was concern as to inconsistent implementation of the voluntary IOSCO Principles for Financial Benchmarks;
- (d) Examine ways to improve the alignment between remuneration and conduct risk at a global level. The Review notes that many steps have already been taken by national and international authorities to address concerns that bonuses and other elements of variable compensation were too closely linked to short-term revenues with insufficient weight placed on longer-term value generation and the risk for the firm as a whole (including risk related to conduct). It states that the Financial Stability Board’s (“FSB”) Principles and Standards on Sound Compensation Practices have been widely implemented. It does, however, express concerns that some regulatory reforms may give cause for concern, including the bonus cap in the EU under recent amendments to the Capital Requirements Directive (“CRDIV”). The Review states that this may be a cause for concern

because, first, as the variable proportion of remuneration falls, the incentive effect of remuneration rules weakens, and, second, as the fixed proportion of total pay rises, firms accumulate larger fixed costs bases which cannot be easily adjusted in times of stress. The Review welcomes the announcement by the FSB in March 2015 that it would review how the incentives created by reforms to remuneration structures have helped to reduce misconduct and whether any additional measures are necessary.

Recommended principles to guide a more forward-looking approach to FICC markets

5. Promoting fairer FICC market structures while also enhancing effectiveness through:

- (a) Improving transparency in ways that also maintain or enhance the benefits of diverse trading models, including over-the-counter.
- (b) Promoting choice, diversity and access by monitoring and acting on potential anti-competitive structures or behaviour. The Review expresses concern, in particular, that market discipline over standards of conduct appears to have been weak or non-existent in many FICC markets. Possible causes include (i) a limited choice of alternative counterparties, (ii) a potential tension between moving business to send a clear signal on conduct standards and (iii) the need to maintain relationships with a range of counterparties to ensure compliance with best execution duties and difficulties in detecting when abuse or misconduct has occurred due to limited post-trade transparency. It believes that the Open Forum to be held at the Bank of England in the autumn of 2015 will provide an opportunity to discuss more innovative ways in which market discipline might be improved.
- (c) Catalysing market-led reform held back by private sector coordination failures. The Review states that a major impediment to changes in market structure may be the absence of a ready means for users to coordinate on a preferred way forward. It notes that standardisation of market terms and practices can assist in making instruments more widely available to all, improving secondary market functioning and pricing. Although it concludes that there is no case for enforced standardisation, it believes there is a case for a better-informed, market-wide debate as to the costs and benefits of alternative market-led solutions. It believes that, for these to be effective, discussions would need to take place across a broad range of market participants and end-users.

6. Forward-looking conduct risk identification and mitigation through:

- (a) Timely identification of conduct risks (and mitigants) posed by existing and emerging market structures or behaviours. The Review states that, although innovation in FICC markets is welcome, it can also create opportunities for new forms of misconduct and change the nature of trading and risk sharing. It believes that some regulatory reforms will address some of these concerns, including new rules on algorithmic trading under the amendments to the Markets in Financial Instruments Directive to come into force in 2017 (“MIFID II”). It recommends, however, that attention be given to new vulnerabilities that may arise in the future.
- (b) Enhanced surveillance of trading patterns and behaviours by firms and authorities. The Review stresses the importance of the requirement for firms to send a “Suspicious Transactions Report” (“STR”) if they believe a transaction which they have arranged or executed might constitute market abuse. It notes that although firms’ STR submissions for FICC assets are increasing, they are only a fraction of those in the equity markets. It states that the FCA will continue to take steps to ensure the STR regime is working effectively in FICC markets.
- (c) Forward-looking supervision of FICC markets. The Review states that identification of misconduct or the potential for misconduct at an early state can enable concerns to be addressed in a more timely and cost efficient manner. It believes that the greater use of early intervention actions in wholesale markets,

particularly wholesale FICC markets, is to be welcomed, particularly where they can provide an alternative to enforcement, while reducing misconduct by firms.

Next Steps

The report states that it concludes the work of the Fair and Effective Markets Review itself. It states that the next step is delivery of the recommendations in letter and spirit. It notes that some of the recommendations can be implemented domestically in the UK by public authorities and market participants. Given the global nature of the FICC markets, it acknowledges that a number of recommendations will require international discussion and coordination, including with the FSB, IOSCO and other national and international bodies. HMT, the BoE and the FCA will provide a full implementation update to the Chancellor of the Exchequer and the Governor of the BoE by June 2016.

Authors

Peter Green
London
+44 (20) 7920-4013
pgreen@mofo.com

Jeremy Jennings-Mares
London
+44 (20) 7920 4072
jjenningsmares@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer's* A-List for 11 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2015 Morrison & Foerster LLP. All rights reserved.

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkt.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.