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FAO: The Fair and Effective Markets Review

BY EMAIL: FEMR@bankofengland.co.uk

29 January 2015

Dear Sirs

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

The City of London Law Society (**CLLS**) represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the **Committee**). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

The Review paper asks 49 questions. The Committee is not seeking to answer all of them. Instead the Committee is focussing on those issues raised by the Review that relate to the possible future regulatory framework that may be applied to firms undertaking business in the FICC markets.

Lessons can be drawn from previous reforms of the regulation of the wholesale financial markets

The Committee considers lessons can be drawn from past changes to the UK frameworks for setting standards in the wholesale financial markets.

1 Some of the issues confronting the Review are similar to those considered between 1998 and 2000 by the FSA in preparing for the implementation of FSMA[1]. At that time the regulatory structural issues concerned (i) what kind of regime should be applied to regulated business conducted between professional counterparties and in particular how the FSA Principles should be applied; (ii) to what extent should such a regime cut back, at least in relation to regulated business, the so-called BoE 'Grey Paper' regime that in part was addressed to investment business that was excluded

[1] Financial Services Authority "Differentiated regulatory approaches; future regulation of inter-professional business" Discussion paper October 1998 ; "The Inter-professional Code" Consultation Paper 47 May 2000 ; "Inter-professional Conduct" Consultation Paper 83 February 2001.

from the scope of the Financial Services Act 1986 by section 43 and Schedule 5; and (iii) what if anything should replace the BoE Grey Paper regime for products such as spot and forward foreign exchange and bullion which were not within the scope of FSMA 2000. In the event the FSA developed a code of Inter-Professional Conduct ("IPC") ("MAR 3"). In scope, the IPC applied to all regulated business conducted with market counterparties[2]. This left unregulated business subject to the Non-Investment Products Code ("NIPs Code") developed and maintained by the BoE. The NIPs Code recognised that standards of compliance under the FSA's Principles would have some relevance also in relation to standards of compliance expected under the NIPs Code.

2 The IPC in MAR 3 included guidance on the applicability of the Principles to inter-professional business; guidance on so-called 'transactions at non-market prices'; taping; and general information on good market practice.

3 The framework provided by the IPC for regulated business remained in place until the implementation of MiFID in November 2007. MiFID included new client categorisation provisions as well as a specific delineation of the application of conduct provisions depending on the categorisation of the client or counterparty[3]. In the event the FSA decided that the case for maintaining the IPC was weak and it was abolished with effect from November 2007. When consulting on the abolition of the IPC the FSA said that, going forward, guidance on the application of the Principles would be moved to PRIN; the rules and guidance relating to 'transactions at non-market prices' would either be moved to COBS or would be included in its quarterly publication Market Watch; and 'best practice' provisions covering issues other than non-market price transactions would also be set out in Market Watch.

4 Thus the implementation of MiFID resulted in a 'diffusion' of materials previously in the IPC to a variety of other FSA source materials including PRIN, SYSC, COBS and Market Watch. This may in turn have made it more difficult for institutions subject to the NIPs Code to use the FSMA 2000 regime as an 'anchor' for standards of conduct in relation to unregulated wholesale markets. We suggest below a case for implementing something like an IPC that could provide a framework for standard setting for regulated and unregulated business conducted in wholesale markets.

The boundary between business that is regulated under FSMA and unregulated business in practice has been a driver of significant compliance resource allocations within institutions

5 The regulatory footprint in the UK is inevitably a driver of relative standards of conduct depending on whether a particular market is subject to regulation and the intensity of regulation. For example, institutions have to devote increasing resources with a view to ensuring compliance with FSMA 2000 requirements as amplified by European legislation. By contrast, several components of the FICC market have not been, directly, subject to regulation under FSMA 2000 or European legislation (e.g. FX, physical commodities). Inevitably this will have been reflected in the priorities and resource distribution of institutions. Institutions will have focussed their attention on fully regulated business lines. Regulators set regulatory priorities that are then reflected in the resource allocation and governance focus of institutions.

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[2] Prior to 2007 client categorisation under FSA rules permitted three categories of client/counterparty: market counterparties; intermediate customers and private customers

[3] MiFID imposed a new categorisation of retail client, professional client and market counterparty together with the prescription of circumstances in which persons could 'move' between their presumptive category; this client categorisation regime was materially different to that which had previously been applied by the FSA, including for the purpose of the IPC.

The enforcement by the FCA of Principle 3 'in a prudential context' is an unsatisfactory basis for its jurisdiction over unregulated wholesale markets

6 In relation to FICC markets, and as the Review observes, the application of the existing UK financial regulatory regime under FSMA 2000 is complex insofar as only some FICC market activity is within the scope of the existing boundary of MiFID. The scope and intensity of the obligations owed by firms in relation to regulated business is calibrated by reference to the status of the customer or counterparty with few and only very high level obligations applying in the case of business undertaken with or for market counter-parties and professional customers. This will change further with the implementation of MiFID 2 that will make some change to the level of protection afforded to market counterparties[4].

7 Some FICC markets (e.g. spot FX and physical commodities) are currently outside the scope of MiFID and for the purposes of FSMA 2000 are treated as 'unregulated'. This however is subject to the potential for the FCA to bring actions against firms in relation to so-called unregulated business under Principle for Business 3. This is illustrated in the Enforcement Notices imposed on five banks in November 2014 in relation to their spot FX business. The Notices proceed on the premise that the banks were under the obligation imposed by Principle 3 to manage the risks associated with its spot FX business given "the potentially very significant impact of misconduct in that business on G10 fix benchmarks, the spot FX markets generally and the wider UK financial system". The existence of this residual jurisdiction for the FCA to at least bring enforcement action against firms in respect of *any* aspect of their unregulated business is arguably unsatisfactory in that it is not supported by any FCA supervisory or policy function with the result that, currently, firms are at risk of enforcement but without there being any articulated standards or guidance issued or endorsed by the FCA against which their conduct may be judged. Currently, the FCA has authority to enforce standards but has no corresponding stewardship responsibility for setting and articulating the required standards. Further, the basis of the FCA's jurisdiction is currently founded on criteria that on one reading should only be invoked in the extreme circumstance of an adverse impact on the integrity of the UK financial system. This macro threshold criterion would suggest that conduct falling short of such impact should be below the FCA radar, even though on an individual basis it may be contrary to what are viewed as desirable standards of conduct and fairness in these professionals markets.

8 The Review appears concerned to identify possible models of regulation that will operate more generally to modify conduct in FICC markets rather than to guard merely against the kind of extreme scenario that currently underpins the FCA's jurisdiction to enforce standards.

9 The FCA's enforcement action against firms using Principle 3 in relation to 'unregulated business' generates an expectation that the FCA will take similar action in the future. For so long as it is the agency with enforcement powers in relation to unregulated FICC markets the FCA may consider itself obliged to have some stewardship role in relation to the standards expected of institutions that are active in these markets. Alternatively, a different body could be entrusted with responsibility to set and maintain standards.

[4] MiFID 2 extends some protections to market counterparties, the obligation to act honestly, fairly and professionally and to communicate in a way that is fair clear and not misleading ; the provision of information and periodic reporting.

Against this background the Committee considers there are probably two broad options that could be adopted in relation to the regulation of the FICC markets:

10 Option 1 would be to establish a new body with the remit to maintain a Code that would establish high level and, to the extent required, more specific standards applicable to inter-professional business in the FICC markets or at least those parts of the FICC markets that lie outside of MiFID and MiFID2. The Code setting body could comprise buy and sell-side industry practitioners as well as independent members. Such an approach could be similar to the Joint Money Laundering Steering Group ("JMLSG") that sets guidelines that the FCA takes into account when deciding whether to bring enforcement action. In practice the JMLSG guidance is an effective industry code for which statutory approval by HM Treasury is needed. An alternative, in the case of a Code for the FICC markets, would be to confer any approval responsibility upon the FCA.

11 Generally the Committee recognises the potential benefits of having standards set by an industry body, in particular, speed, flexibility and the ability to create a regime that it is internationally compatible with developing commercial practice. Option 1 avoids the danger of 'regulatory creep'. Option 1 would allow for the creation of a Code that could be addressed to all (authorised and un-authorised participants) in the FICC markets. Primary legislation would be required, however, to render such a Code enforceable against un-authorised persons.

12 Option 2 would be to align the FCA's existing enforcement powers in relation to FICC markets with a more explicit standard setting responsibility. This could be done building on its existing powers in FSMA 2000 to make rules and issue guidance in relation to unregulated activities carried on by authorised firms[5] or primary legislation might be needed to enlarge the scope of 'regulated activities'. One benefit of this approach would be to avoid the creation of a new quasi- regulatory body in a so-called 'Twin-peaks' regulatory structure. Giving policy and standard setting responsibility to the FCA may also make it easier to make standards that effectively straddle MiFID and non-MiFID business.

13 Option 2 presents some potential downsides. There might not be appropriate differentiation between the standards to be applied to different parts of the FICC markets. Without any appropriate differentiation in its statutory objectives the FCA may consider itself constrained to adopt a 'blanket' approach to all FICC business.

14 Whatever option is chosen the efficacy of new standards for inter-professional conduct will depend upon a number of factors. The Committee would draw attention to the need for any new standards to:

a. Provide examples of both good and bad practices, avoiding the tendency merely to cite examples of unacceptable behaviour;

b. Ensure any 'guidance' is either included within the published standards or is visible through links from the standards to the guidance; otherwise the regulator's commentary becomes ever more dispersed and potentially invisible to those who need to see and absorb it[6]; and

c. Encourage or require institutions to use positive acceptable behaviours by individuals as a basis for awarding variable remuneration.

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[5] Section 137A (1) (b) combined with sections 1 B, 1 D and 1 H

[6] This point is of general application; the Committee would urge the Review to include this point in its development of an effective regime

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Peter Richards-Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com, or Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours faithfully

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THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

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