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Via electronic submission: FEMR@bankofengland.co.uk

Fair and Effective Markets Review
Bank of England
Threadneedle Street
London EC2R 6DA

Fair and Effective Markets Review: How fair and effective are the fixed income, foreign exchange and commodities markets?

Dear Sir/Madam,

State Street Global Markets appreciates the opportunity to comment on the consultation paper (CP) issued as part of the Fair and Effective Markets Review. This response is solely on behalf of State Street Global Markets and does not necessarily represent the views of WM Reuters[1].

State Street Global Markets, a division of State Street Bank and Trust Company, provides specialized investment research and trading in foreign exchange, equities, fixed income and derivatives. Its goal is to enhance and preserve portfolio values for asset managers and asset owners. From its unique position at the crossroads of global markets, it creates and unlocks value for its client with original investment behavior research, innovative portfolio strategies, trade process optimization, and global connectivity across multiple asset classes and markets.

State Street Global Markets' research team of leading academic and industry experts is committed to continually advancing the science, including theory and application of its proprietary investor behavior research and innovative portfolio and risk management technologies.

Our foreign exchange business serves over 900 investment managers, central banks, sovereign wealth funds, pension funds, insurance companies and hedge funds. We regularly rank in the top 10 foreign exchange ("FX") dealers for market share with investment managers, and last year ranked 16th in global market share amongst all banks[2].

State Street Global Markets encourages the authorities to work with the industry to build on existing good practices in order to deliver a fair and effective FX market.

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[1] WM Reuters administers the WM 4pm Fix and is a joint-venture of The WM Company, a wholly owned subsidiary of State Street Corporation and Thomson Reuters

[2] Euromoney FX Survey May 2014

Prior to commenting on the specific issues in the CP we to wish highlight that sufficient consideration and analysis needs to be given to regulatory initiatives which are currently in force, under implementation or which are being proposed.

Current regulatory measures such as MiFID and MAD are already in place and it is important to evaluate how effective these have been in creating effective monitoring and transparency practices in the market. Further to this, it is essential to take account of the fact that firms are in the process of implementing a number of new initiatives such as MiFID II and MAD/MAR which both have significant consequences for market practices and it will be important to ensure regulatory consistency when coming forward with any new regulatory initiatives. MiFID II in particular is likely to have profound changes to market structures, trading processes and liquidity and it will be important for regulators to have a clear understanding of the impact of these changes before proposing new rules. We also want to specifically highlight the current European Commission's proposal for a benchmarks Regulation ('proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts') and would urge regulatory authorities to work together to ensure regulatory consistency and avoid the duplication of rules relating to the FX markets.

The framework developed by the Fair and Effective Markets Review to evaluate the fixed income, foreign exchange and commodities (FICC) markets is an important contribution to help highlight areas where change may not yet have gone far enough to reinforce public confidence. State Street Global Markets would like to confine its comments to the FX market where it is a significant principal market maker as well as a market participant.

The market maker model in FX has been effective in supporting liquidity and enables market participants to trade in and out of positions without causing damaging price volatility. FX is an asset class in its own right but also underpins the global payments system as well as facilitates global trade and capital flows. Given the important role the market maker model plays in reducing price volatility and enabling investors to raise finance we would caution against regulatory proposals to extend derivative legislation to include spot FX which could undermine this role. Further to this, it is important to note that market making, and the benefits it brings, will not be helped by a narrow definition of spot FX under MiFID II.

Market microstructure

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

The biggest impediment to the development of fully transparent and independent netting and execution facilities for transacting foreign exchange fix orders is dealers ongoing provision of "free" mid-rate benchmark (London WM 4pm fix in particular but also the 10am BOT Tokyo fix) transaction services to their investment manager clients. Some of these investment managers in turn feel they should continue to accept these mid-rate benchmark trades as long as they are being offered in order to fulfil their fiduciary duty to limit their index tracking error.

The Financial Stability Board's (FSB) Final Report on Foreign Exchange Benchmarks recognized that continued provision by FX dealers of mid-rate FX benchmark trading services had led to mis-aligned incentives which had resulted in concerns being raised about the integrity of FX rate benchmarks. The FSB's paper noted that; "These concerns stemmed particularly from the incentives for potential market malpractice linked to the structure of trading around the benchmark fixings[3]." The FSB made two recommendations that specifically address this issue. First, the FSB's recommendation seven states; "The group recommends that fixing transactions be priced in a manner that is transparent and is consistent with the risk borne in accepting such transactions. This may occur via applying a bid-offer spread, as is typical in FX transactions, or

[3] Financial Stability Board, Foreign Exchange Benchmarks Final Report, September 2014, page 1

through a clearly communicated and documented fee structure such as a direct fee or contractually agreed price[4]." Second, the FSB's recommendation fifteen states; "The group recommends that asset managers, including those passively tracking an index, should conduct appropriate due diligence around their foreign exchange execution and be able to demonstrate that to their own clients if requested. Asset managers should also reflect the importance of selecting a reference rate that is consistent with the relevant use of that rate as they conduct such due diligence[5]." State Street Global Markets supports these FSB recommendations, and believes that they should be adopted as best practice by FX dealers and investment managers.

When considering possible solutions investment managers should bear in mind that there are a range of choices including State Street Global Markets' innovative Agency FX service. This service is fully independent of State Street Global Markets' principal foreign exchange market making business. The Agency FX service enables clients to outsource their currency trading to a dedicated and segregated agency execution desk within State Street Global Markets. This team has sophisticated trading and price discovery tools, access to deep market liquidity and comprehensive transparency. The service is focused on delivering transparent execution and credit diversification through access to broad liquidity and an infrastructure designed to minimize operational risk.

Further to this, State Street Global Markets operates TruCross/FX which is an automated FX spot benchmark pricing and execution solution designed to give institutional buy side clients access to WM/Reuters mid-rate based pricing, less fully disclosed commissions. Trucross/FX provides clients who use WM/Reuters benchmark rates with an automated process to securely and confidentially submit benchmark orders for pricing and execution. Once executed, Trucross/FX will direct trades to a bank of the client's choice for settlement. We believe that TruCross/FX is the only live industry-led initiative that provides an independent netting and execution facility for transacting benchmark fixing orders for institutional clients.

Benchmarks

Q22: What steps could be taken to reduce the reliance of asset managers and other investors on benchmarks?

FX benchmarks are a valued and important service used predominantly, but not exclusively, by investment managers in the FX markets. Transacting at a benchmark provides transparency, liquidity and standardisation that directly benefits end investors. As such, investors will continue to drive changes in the market that create more efficient transparent and equitable ways to trade at established FX benchmarks.

One of the most popular FX benchmarks used by investment managers is the WM 4pm fix[6]. The FSB final report on FX benchmarks published on 30 September 2014, points to how the widespread use of a particular market benchmark can lead to concentration of order flow around a fixing which could provide incentives for market mal-practice. Rather than dis-incentivising investment managers from using the benchmark, we believe that a change in market practice, either sanctioned at an industry or regulatory level, could allow firms to continue to provide this service to the investment management community but importantly also removes any potential for possible market abuse.

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[4] Financial Stability Board, Foreign Exchange Benchmarks Final Report, September 2014, page 28
[5] Financial Stability Board, Foreign Exchange Benchmarks Final Report, September 2014, page 31
[6] WM Reuters administers the WM 4pm Fix and is a joint-venture of The WM Company, a wholly owned subsidiary of State Street Corporation and Thomson Reuters

Q23: What additional changes could be made to the design, construction and governance of benchmarks?

We wish to specifically endorse recommendation fourteen[7] in the FSB's Foreign Exchange Benchmarks Final Report. Providers of asset indices that are used for execution should be encouraged to publish two index values, one that uses WM/Reuters bid rates and another that uses WM/Reuters offer rates. We believe this could play a significant role in ensuring that the calculation of asset indices which use foreign exchange fixes are fit for purpose.

In addition, we believe the market place needs to adjust current best practices to ensure that confidence in the fair and efficient execution of benchmark orders is assured. In particular, we agree with the FSB's recommendation that dealers should not provide mid-rate benchmark pricing as principal, but should instead price these transactions as they do all others, at either bid (buy rate), or offer (sell rate). This could be achieved by codifying the removal of the activity of mid-rate benchmark execution from a firm's principal FX trading businesses.

Agency FX is another market driven advancement on present practices. It is a distinct and independent service fully separate from the principal trading business. Agency FX execution services which serve to segregate all information about benchmark orders and charge a fee (invoiced or incorporated into an agreed mark-up of the execution price) for execution, in line with the normal practice for commercial transactions, are practical and appropriately align incentives for good conduct and can meet investment managers overall objectives.

Either of these approaches would alter the incentives for inappropriate conduct, as opposed to banks providing the principal mid-rate benchmark trading service for free as is common today. We would particularly welcome working with the Review to share our ideas as to how the above can be achieved and would again like to highlight our Agency FX and TruCross/FX services as outlined in our answer to question nine.

Standards of Market Practice

Q28: Box 7 on pages 36–37 discusses a number of uncertainties over FICC market practices reported by market participants, including: the need for greater clarity over when a firm is acting in a principal or an agency capacity; reported difficulties distinguishing between legitimate trading activity and inappropriate front-running or market manipulation; and standards for internal and external communication of market activity. To the extent that there are uncertainties among participants in the different FICC markets over how they should apply existing market standards in less clear-cut situations, what are they?

State Street believes that before entering into a bi-lateral relationship with an eligible counterparty, clear disclosures should be made by both parties as to the nature of the trading relationship. Specifically it should be made clear whether a counterpart is acting in a principal or agency capacity to the transactions. The obligations and duties of a principal market maker in the foreign exchange market should be clearly documented within the "code of conduct" structure described below.

Q29: How could any perceived need to reduce uncertainties best be addressed: (a) better education about existing standards; (b) new or more detailed market codes on practices or appropriate controls; or (c) new or more detailed regulatory requirements?

We fully support "developing a global code (or codes) of conduct for FICC markets, written by the market in terms that market participants understand…and stronger penalties for staff breaching

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[7] Financial Stability Board, Foreign Exchange Benchmarks Final Report, September 2014, page 30

internal guidelines"[8]. We believe such codes should follow from previous examples of where regulators have provided guidance, such as the Financial Conduct Authority's 'Principles for Business' and where central bank foreign exchange committees have established codes of conduct for the FX markets.

These codes would contain high level principles agreed by the industry and backed with regulatory approval. We believe that in order to operate effectively firms and individuals must be in a position to judge appropriate conduct in a variety of different situations. The principles embedded in codes of conduct, should lead to the creation of specific training programmes which would include case studies that help resolve issues where there may be potential areas of uncertainty. It is important that front office staff know and understand these principles and firms provide a clear mechanism for escalating grey areas of concern.

Q31: Should there be professional qualifications for individuals operating in FICC markets?

We support the adoption of compulsory professional qualifications to ensure that front office staff have up-to-date knowledge and are assessed as fit and proper to carry on their activities. We believe such qualifications should be sanctioned by regulators with scope for possible market wide qualifications if agreement is possible across jurisdictions. We support the requirement that FX front office staff pass a qualifying exam which should include a certification to abide by an industry code of conduct.

Q32: What role can market codes of practice play in establishing, or reinforcing existing, standards of acceptable market conduct across international FICC markets?

We support establishing globally consistent standards and we therefore support the proposals currently being put forward by the Association of Financial Markets in Europe ("AFME"), as part of their response to this CP, in relation to advocating uniform code of conduct frameworks of high level principles that are global but allow for appropriate regional variances in operational practices.

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?

Whilst firms already have a range of systems and controls in place to detect misconduct it is appropriate for firms to continue to investigate how to further strengthen this surveillance by using new and enhanced tools including electronic surveillance of both communications and transactions. We endorse this as part of the development of an appropriate risk culture.

Electronic surveillance of communications, such as chatrooms, emails and phones, is a valuable deterrent to inappropriate behaviour and it is important that appropriate investment is made in these areas. However, the most important key to catching malpractice is the alertness of staff who understand their duty to escalate suspicious or irregular behaviour of market practices and we believe formal training and certification programmes, as highlighted above, could help achieve this.

Whilst increased surveillance has an important role to play in deterring malpractice we believe firms need to take a clear role in fostering culture change across the industry. Senior management needs to evaluate existing policies and procedures and make changes where

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[8] Fair and Effective Markets Review: How fair and effective are the fixed income, foreign exchange and commodities markets?

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appropriate and ensure middle management and below have a frim understanding of the levels of integrity and accountability expected of them.

Other issues

Further to our point about the importance of the market maker model in FX and the detrimental impact bringing spot FX under derivatives legislation could have, we believe there is a need for a clear definition of what constitutes spot FX and what constitutes forward FX as this is crucial to a truly fair and effective FX market place. The clarification of the definition of FX spot contracts is important since it will provide necessary guidance for firms and end-users to determine their regulatory requirements and obligations. The definition affects existing requirements under EMIR and will also affect other obligations in the future under both EMIR and MiFID II. In addition, clarification will facilitate consistency in the EU and will be an important step towards global harmonization of FX and derivatives regulation. We believe the current ongoing level two work under MiFID II is an appropriate means for the European Commission and the European Securities and Markets Authority (ESMA) to propose such a definition.

Summary

Once again, we encourage the authorities to work with the industry to build on existing good practices in order to deliver a fair and effective FX market. We believe that the overall structure of the FX markets is fundamentally sound with the market maker model playing a vital role in providing liquidity and supporting the real economy and any future regulatory measures should take careful account of this.

However, we fully appreciate that recent issues have undermined public trust and it is important to look at ways in which best practices can be amended to prevent future abuses. We hope we have pointed to a number of these; improved codes of conduct devised by the market which are sanctioned by regulators and implemented by firms, further amendments to the way benchmarks in FX are administered and additional surveillance to uncover malpractice.

Thank you once again for the opportunity to comment on the important matters raised within this CP. Please feel free to contact me should you wish to discuss State Street's submission in greater detail.

Sincerely,

Mark J. A. Snyder

Executive Vice President
Global Head of Sales & Trading and Research
State Street Global Markets