Standard Chartered

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Fair and Effective Markets Review
c/o The Bank of England
Threadneedle Street
London
EC2R 8AH

30th January 2015

Dear Sir or Madam,

We are pleased to provide our comments on the *"How fair and effective are the fixed income, foreign exchanges and commodities markets?"* consultation document (part of the Fair and Effective Markets Review ("FEMR" or "Review") being undertaken jointly by HM Treasury, the Bank of England and the Financial Conduct Authority (the "UK Authorities")). We very much support the Review's objective of helping to restore public confidence in the fixed income, commodity and currency ("FICC") markets by addressing any remaining frailties in the conduct, practices and market infrastructure that underpins these markets. We note that a great deal of legislation and regulation has been developed that will help to improve the proper functioning of these markets, such as the reform and regulation of major benchmarks, the Markets in Financial Instruments Directive and Regulation ("MiFID II"), and the Market Abuse Regulation ("MAR"). However, as the implementation of many of these reforms is still underway, their ultimate effectiveness in raising standards is unclear, so we believe that it is important for the Review to arrive at some conclusions on the effectiveness of the reforms already being implemented.

Given the global nature of the FICC markets, it is appropriate that the Review is mindful of the broader international context by seeking the views of the UK Authorities' peers and international authorities. It is important for authorities such as the Financial Stability Board ("FSB"), the International Organization of Securities Commissions ("IOSCO"), the European Commission, the European Securities and Markets Authority, the Federal Reserve, the ASEAN+3 Bond Market Forum, IOSCO's Asia Pacific Regional Committee and other emerging markets regulatory bodies to be fully engaged in developing additional rules for regulating the FICC markets given London's role as one of the leading international financial centres. Across the many markets in which we operate, regulators and policymakers have been focused on deepening their FICC markets over many years and have looked to the UK and other developed markets for guidance and insight on how best to do so. As well as being alert to any ongoing issues in FICC markets, it is also important to recognise their value to the real economy in supporting access to debt finance and the provision of risk management services to individuals, businesses and institutions.

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We believe that there is a need for a set of principles to guide the work of the FEMR and the recommendations that it develops. These should include: (i) application of the regulatory scope to all FICC activity (whether or not currently regulated), (ii) avoidance of duplication with existing legislation and regulation, (iii) internationally-consistent application, (iv) promotion of competition, (v) provision of clear guidance on conduct and its enforcement across FICC markets globally, and (vi) enhancement of the depth and liquidity of markets.

The key points that we would like to make in response to the consultation are:

- **The regulatory environment is still evolving, so introducing additional reforms before the existing ones have been fully "bedded in" should only be done where policy gaps are identified.**

  The full extent of the many reforms that are being implemented and other initiatives focused on improving standards in banking are still being implemented or are subject to consultation. For example, the central clearing and margining of derivatives under EMIR is yet to start, the MiFID rules on both conduct and transparency will not be in force until early 2017, benchmarks regulation in the UK and Europe is work in progress, and the UK Banking Standards Review Council is only just up and running.

  Although some of the rules already in force, such as the Capital Requirements Regulation ("CRR"), are starting to change market participants' behaviour, it is likely that their full effect is yet to work its way through the system. In addition, how those prudential rules interact with the various market reforms that are on a slower timetable may also lead to changes that have not been anticipated, and reveal new risks which will require further policy responses. Therefore, we would urge caution against mandating further changes in the short-term other than where clear deficiencies are apparent.

- **Further reform of the FICC markets should be driven and coordinated at the international level due to their global nature and mobility.**

  Financial markets in general are global in nature, and the FICC markets are arguably more so. This is especially true when it comes to products such as derivatives or FX: a great deal of derivatives trading is done cross-border, and FX underpins the global payments system. How regulation works across national and regional boundaries is therefore of crucial importance – to avoid regulatory arbitrage, prevent the balkanisation of financial markets and the fragmentation of liquidity across national or regional borders, as well as to avoid placing unnecessary costs on firms and their clients when trying to comply with duplicative or conflicting rules.

  We have over the past few years witnessed several instances of extra-territorial regulations which have created significant challenges for cross-border firms as a result of insufficient international coordination in the development of the detailed rules. This is not merely a compliance issue for financial institutions, requiring for example the development of separate reporting systems for different regulators' over-the-counter derivatives reporting provisions. It also has consequences for end-users in the wider economy as a result of market participants being excluded, often from jurisdictions other than those originating the extra-territorial regulations. For example, the recognition process for non-European central counterparties under the European Market Infrastructure Regulation ("EMIR"), or the inconsistencies in the draft rules for uncleared derivatives, could negatively impact both the

firms themselves and end-users, preventing the latter from hedging their risk, therefore increasing systemic risk. In the case of Article 25 of EMIR, EU firms may be shut out of some jurisdictions as the inability to clear would likely affect a significant portion of their client franchise. Those markets would suffer a loss of liquidity through a wholesale withdrawal of EU firms. Potentially the most acute example of unintended consequences of cross-border regulation has been the fragmentation of liquidity brought about by the Swap Execution Facility ("SEF") rules. ISDA research shows that European dealers are opting to trade with European counterparties following the introduction of organised trading on SEFs in the US. The market now appears split between US and non-US liquidity pools.

It is also important to recognise that many sectors of the financial markets are very mobile. There is a risk of regulatory arbitrage. The way to avoid this is to calibrate the detail of the rules carefully to ensure they meet the policy aims without creating room for unintended consequences. For example, the new rules on non-equities transparency in MiFID II / MiFIR aim to balance the objective of increased transparency with the importance of secondary market liquidity.

Overall, we believe that without effective coordination of cross-border rules, markets will tend to become less liquid and transparent, with a greater concentration of market participants and less choice for clients. International banks can play a key role in road-testing the practical implementation of international new rules and helping to encourage global adoption.

- **Increased competition should be a key driver of more fair and effective markets, although regulation, together with changing monetary policy and economic factors, has played a part in reducing the number of participants in some markets.**

  In some asset classes, there are arguably fewer participants now than there used to be, e.g. there are now fewer banks willing to make markets in fixed income instruments, particularly in corporate bonds, and some major institutions have withdrawn from fixed income sales and trading altogether. This has been driven at least in part by the Basel III capital rules which have significantly increased the costs of holding inventory. Whilst recognising that many of the regulatory changes and their consequences were deliberate policy choices, it is important to be mindful of the cumulative impact of the changes over time on competition.

- **Recommendations emerging from the FEMR should focus primarily on markets, products and activities rather than institutions to ensure that all participants are covered, rather than just the regulated firms.**

  It is also important to keep the regulatory perimeter under constant review to ensure that the boundary is in the right place and that new or different risks are not being created outside of the regulated sector. This has always been important but is particularly so now, given the structural changes occurring across the financial services industry driven in part by new regulation. Banks are getting disintermediated from certain activities, with the buy-side and other players stepping in to provide products and services that were either previously provided by banks or that are completely new.

- **Liquidity is a significant issue and the FEMR needs to be mindful of the impacts that its recommendations may have on what many commentators refer to as a fragile system.**

  There is evidence that liquidity is becoming a significant issue in FICC markets, and it has already attracted regulatory attention in the UK and elsewhere. The bouts of volatility witnessed last year across a number of asset classes impacted even the most liquid instruments, showing significant price spikes in very short periods of time. At least some of this was blamed on the changing nature of liquidity provision and modes of trading, particularly the withdrawal or scaling down of market making by banks.

  Regulatory changes, particularly the Basel III capital requirements for holding traded credit instruments such as corporate bonds, the shift to mandatory central clearing, the margining of uncleared derivatives, and the forthcoming rules on market transparency across the entire non-equities universe of products, all lead to a reduction in banks' inventories and a reluctance to make markets in some products and to the required depth. Regulators concede that this may lead to increased volatility, particularly in times of stress, if there are no market makers willing to take on risk and absorb some of the shock resulting from policy adjustments or market moves. At the same time issuance is increasing globally, so we are likely to witness more frequent liquidity dislocations and strains in the future. It is also likely that less liquid assets will be most affected, with liquidity bifurcating between high quality liquid assets and other assets.

- **Banks should have well-developed codes of conduct which articulate clearly the standards of conduct and behaviour expected from all staff.**

  We recognise and support the overall objective to improve professional standards, codes of conduct and culture in the banking sector in order to restore trust and ensure that conduct is of the highest standard. Codes of conduct are subject to continuous review to ensure that they reflect changes in market practices and regulatory requirements. Through that mechanism, combined with appropriate performance management processes, staff take personal responsibility for their actions.

  Firms need to ensure that they have a clear approach to conduct. This needs to feed from the top of the organisation to the bottom, and be reflected in and driven by the culture and values of the firm. However, in addition, the key processes with a conduct element need to be designed to reflect the approach to conduct, as well as ensuring the right outcomes for the firms' clients and the markets in which it operates. The governance processes need to ensure that controls highlight areas of weakness which are communicated to appropriate individuals or groups with authority to act, that roles and responsibilities are understood, and that all of this is embedded so there is a process of continual challenge and review. In all this, a balance between culture and controls is fundamental – they are both needed to ensure the right conduct.

  We believe that it is important for us to refresh our code of conduct every few years to ensure that it remains up-to-date and relevant, and to encourage our staff to really engage with it. Senior management promoting and demonstrating the importance of adherence to the code is critical to having a strong culture and the desired regulatory outcome. There should also be continuous engagement with staff through communication, training and awareness raising.

There is certainly a case to be made for the promulgation of robust conduct and behavioural standards across the industry; industry-wide codes offer a potential mechanism for achieving this, but it is important to recognise the trade-offs between market practices and firm-specific codes.

There are currently draft Rules of Conduct being consulted on by the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA") ("Strengthening accountability in Banking: a new regulatory framework for individuals" – PRA CP14/14 and FCA CP14/13). As a result we would recommend waiting to see the outcome of those consultations before considering detailed technical guidance regarding working practices in specific lines of business.

There has been some debate about whether there should be an industry-wide code of conduct and / or set of banking standards. Whilst we are open to the idea, it is important to recognise the trade-offs. An industry code has the advantage of helping to share best practices and imposing minimum standards, but it has the disadvantage of being less likely to be owned by the individual organisation or of resonating with a firm's culture. Moreover, for an international bank, there is a huge benefit in having a code of conduct, or perhaps multiple codes for different activities, that are consistent across geographies and reflect the cultural and geographic mix of its business. We believe that there is a need to have a much more in depth debate about the relative merits and practicalities of developing a universal Code or Codes of Conduct for FICC markets including the extent to which they should be approved by one or more regulatory authorities and used as an enforcement tool.

- **Performance assessment and remuneration should be an integral part of banks' incentive structures and should incorporate an assessment of compliance with their Codes of Conduct and expected standards of behaviour.**

  It is important to ensure that the way values are demonstrated by employee behaviour is given due weight in remuneration decisions. Supervisors should require banks to demonstrate how they take account of behaviours and values in remuneration decisions. All banks ought to have explicit mechanisms to evaluate how individuals achieve their objectives, not just what they achieve. At Standard Chartered we have operated such a system for some time, with a numeric scale for financial and other dimensions of performance, and an alphabetic scale to rate values.

  We do not think it necessary or desirable to impose a uniform system across banks, because it needs to align with an institution's culture and build on existing processes. What matters is that every bank should be able to demonstrate that it has an approach to evaluating values and behaviour that has a real impact on remuneration decisions and career prospects. There are some areas where consensus may be the best approach, in particular in developing metrics for measuring conduct and adherence to culture, behaviour and processes.

- **We welcome and strongly support the UK authorities' efforts to improve the robustness of benchmarks. Critical benchmarks should have a strong governance framework to prevent potential abuses and protect market participants and investors.**

We believe the recommendations from the Review to extend the LIBOR regime to key FICC benchmarks will also contribute to the consolidation of London's reputation as a leading financial centre.

We strongly believe the efforts made at the international level by both the FSB and IOSCO are fundamental to the wider benchmarks regulatory reform project, in particular to ensure that specific jurisdictional initiatives do not introduce conflicting and irreconcilable frameworks that prevent cross-border activities.

FICC markets are global in nature and national / jurisdictional approaches could lead to competitive distortions, so it is critical that national approaches are proportionate and sufficiently flexible to enable regulatory convergence to be achieved and avoid market fragmentation. The European Commission's draft benchmarks legislation requires equivalence decisions on all the jurisdictions that host benchmarks used by European financial and non-financial firms and could have serious unintended consequences such as the withdrawal of liquidity for specific products and the inability to hedge risks. This risks creating an unlevel playing field, particularly with the US not planning to implement equivalent regulation, and would result in a significant competitive disadvantage for European market participants operating beyond Europe.

- **We believe that the current FX market structure is working effectively and supporting the requirements of firms' clients and end-users. We would caution against making structural changes to this market.**

The structural dynamics of various FICC markets including FX, in particular their principal-to-principal nature, are fundamentally different from agency or exchange based markets. Most notably clients are the ultimate beneficiaries of not paying commission (as in an agency or exchange model), as well as potentially benefiting from free optionality when placing limit and stop orders with principal capacity FX dealers. Where FX dealers acting in a principal capacity monetize the inherent optionality of client limit and stop orders, they do so on an 'at risk' basis. Without the ability to monetize the optionality offered to clients, principal capacity FX dealers would either be unmotivated to offer limit and stop order services or would move to a commission based model.

Moving the FX market to an agency or commission based model could have many unintended consequences which would largely be at the expense of clients who would ultimately bear the costs of execution of such a structural change to the market. While transparency might improve, further unintended consequences to market liquidity and volatility, as well as the passing on of costs to clients, would likely have sufficiently detrimental effects on the proper functioning, depth, and breadth of the global FX market.

Standard Chartered is of the view that the FX markets are broadly functioning to the benefit of all market participants and does not believe that there are any fundamental concerns amongst clients and end-users about their fairness and effectiveness. Any significant structural adjustments to the market are likely to have broad and unintended consequences to both the liquidity and client outcomes of the global FX market and therefore should be underpinned by broad based consensus among all market stakeholders – participants, end-users and regulators. Our market practitioners are eager to have a more detailed conversation on this specific point, to further explain our views and work through some

specific examples of how the FX market currently operates in practice and how structural changes could result in negative client outcomes.

- **Transparency and reporting will play a key role in creating fair and effective markets, particularly if the new reporting requirements are used to monitor market developments on an ongoing basis.**

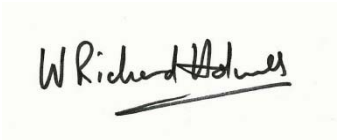
  Whilst we agree with the key tenet of the Review that transparency plays a key role in creating fair and effective markets, we would caution against it being seen as an end in itself for all products and across all FICC markets.

  There is a difference between the information provided to regulators and that provided to the market. For the former, EMIR reporting of derivatives to trade repositories and MiFID transaction reporting will create a step change in the breadth of data available to regulators. We believe this is a positive development and hope that regulators will be able to make use of the information to gain a better picture of what is going on in the market on an ongoing basis. This should allow them to act pre-emptively in response to market irregularities and suspicious transactions.

  The additional information which will be provided to the market in the form of MiFID pre- and post-trade transparency requirements is also a welcome move. However, as mentioned above, we hope that the EU regulators take time to calibrate how the transparency provisions are applied in order to avoid further damaging secondary market liquidity in some products.

In conclusion, we are very supportive of the objectives of the FEMR and would like to participate actively in helping to improve the conduct, practices and market infrastructure operating in the FICC markets globally, where they are required. We have participated in a number of FEMR events in London and Singapore, and would encourage the Review to seek views from similar events in other markets, both developed and developing. We stand ready to help develop uniform, practical standards that can be implemented around the world that will make FICC markets fairer and more effective, without unduly restricting their ability to serve the real economy.

Yours faithfully,



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