Fair and Effective Markets Review

A submission from The European Bond Commission (EBC) of the European Federation of Financial Analysts' Societies (EFFAS).

The EFFAS European Bond Commission (EBC) is the standing commission of EFFAS charged with the examination of matters relating to the markets in fixed income securities in Europe. Its specific objectives are:

- to raise and set the standard of professional and academic analysis of fixed income securities and their derivatives throughout Europe.
- to encourage developments improving the efficiency of European bond markets.
- to provide authoritative information on the bond markets in Europe.

Since its inception almost 50 years ago the Bond Commission representation has grown steadily throughout Europe and the EBC offers a unique insight into the structure, composition and current trends in each European market as well as a holistic view across all these bond markets. The EBC includes members from across the entire gamut of fixed income related areas, including financial and credit analysis, fund management, pension areas, settlements, custody, legal, corporate finance and so on.

Through its highly regarded publications programme and its regular meetings held throughout Europe, the EBC makes an invaluable contribution to the debates and discussions preceding many of the changes in national market practices as they continue to evolve and move towards a single European capital market. The EBC maintains close links with numerous other international organisations such as the OECD.

In particular the EBC has set globally accepted standards on the accepted ICMA standard yield calculation, the creation and calculation of bond indices, the structure and calculation of different types of yield curves and is now working on establishing standards for the derivation of a truly default-risk-free rate.

Preliminaries

We understand that the UK member society of EFFAS, the Chartered Institute of Securities and Investment (CISI) will also be submitting a response, which will focus upon markets from the perspective of UK retail investors. Though we are aware that such distinctions are inevitably somewhat arbitrary, this submission, accordingly, has an institutional or wholesale concentration. In common with the review, we do not believe that the degree of sophistication of an investor in any way admits practices of misconduct. In this light, we particularly welcome the Review's box 3 explaining the concept of caveat emptor in this context. Our response does not cover commodities markets, as these are beyond our EFFAS remit and expertise.

We are in broad agreement with the objectives of the review. However, we feel that the review, in considering recent misconduct, overlooks or downplays the role of institutional investors operating

in these markets. It is certainly not unknown for some such institutional investors to offer incomplete and misleading information to traders in order to effect transactions on advantageous terms.

We are also concerned that the concept of market discipline should again be present. The experience prior to and during the crisis suggests strongly to us, that this concept is flawed, inasmuch as it relies upon prices reflecting real economic value in most regulatory applications. However, in the sense that it could mean such things as ceasing to deal with those who have demonstrated a lack of integrity, it is to be encouraged, though it perhaps needs co-ordination.

One of the concerns we have developed in our own analysis of the recent scandals is the role of participant "free-riding"; for example, when agreeing to transaction pricing at a foreign exchange fix. This is a recurrent issue with synthetic products in both FICC and equity markets. We also have issues with the volumes of synthetic products in the sense that these often represent claims on the financial rather than non-financial sector.

We would also offer the caution that the proposed European Capital Markets Union together with many other regulatory changes in train, hold the prospect of changing our financial markets radically. With this in mind, we would point out that our responses are based upon our best estimates of the effects of those changes, but these are highly qualified by these.

As we believe it to be a better way to get our views across, we have chosen to offer commentary upon the text in the consultation rather than respond to the explicit questions posed. We have used a blue typeface to indicate quotations from the consultation.

Introduction

Before moving to a detailed discussion of the consultation issues, we feel that we should make a few overarching points.

In our opinion, the commentary in the review is deficient in one important regard in that it does not consider sufficiently the function or purpose of particular FICC markets. In many cases, this purpose has direct bearing on the market structure and practices. For example, the money markets are markets for liquidity and these thrive upon ignorance given the role of collateral. The primary bond market is a market for capital and indeed given the changing role of stock exchanges, which no longer supply meaningful amounts of capital to companies, are now the predominant source for many large companies. We would note that over 70% of private sector investment is now financed from retained earnings or internal resources. The significance of the secondary bond market to the primary market can easily be exaggerated; it is merely ancillary, and in our view, could exist at far lower levels of trading than now seen without restricting issuance excessively. We believe that the principle advantage to be gained from looking at markets in this functional manner is that it will become obvious than some solutions, such as transparency, have relevance in some contexts or markets, but not others.

The discussion (Box 2) of the evolution of the FICC market-making model troubles us. The gilt markets and many other government securities markets do have explicit market makers, frequently under contract, whose role is well defined. It is also usually a privileged role, with explicit incentives such as access to central bank inventory finance. Outside of these markets, the market maker model only truly applies in the major currency foreign exchange markets. The central issue here is that there needs to be enough turnover activity within or at the spread to warrant the potential risk exposure.

Notwithstanding appearances to the contrary in corporate bond markets, transactions are in fact almost always (and as a rule) bilaterally negotiated. In this trust between the counter-parties plays a central role and this can often be explicitly reflected in prices. Though they find their substance in transactions, these are relational rather than transactional finance. We would classify the majority of sell-side participants as traders rather than market makers. It should be understood that this relation is intrinsically co-operative, rather than adversarial.

The relations between institutional investors and traders are usually far broader than the simple execution of secondary market transactions; for example, bundled services such as economic commentary and distinct services such as corporate finance advice. It is frequently based on an understanding of mutual reliance, best supported by the development of mutual trust rather than by the simple adhesion to any number of rules or regulations.

In the period since the crisis, in response to the reduced role of the traditional traders, we have seen a significant increase in the number of agency brokers, the better of whom provide more than a search and price discovery service among traders, which includes the active placement of securities left for sale by institutional investors with other institutional investors. We would also note that many traditional dealers also now actively solicit and conduct much more business of the basis of orders left with them to work, on an agency basis.

These relational differences should be noted when considering differences between traditional OTC markets and modern computer based trading systems – the anonymity of many such systems precludes the development of trust, though the reliability of such systems may engender confidence. We may have confidence in a computer system in the sense that it is reliable, but that is not the synonymous with trust. In our experience trust based co-ordination is both more flexible and more innovative. Indeed many institutional investors use computer-based trading systems because the activity routed and executed in this manner is insignificant in the context of relationships. This can also hold true in another context, the use of multi-lateral trading systems. Here the securities traded are commoditised and activity in them will add little to relationships.

It should also be recognised that prices are simply not in fact continuous. Indeed, some official actions clearly operate through a mechanism of surprise and rapid discontinuous price change. There is a further point to note about the demand for trading activity in bonds, which is that there is very little natural trading demand once these have seasoned, that is to say, once the majority of an issue is placed with investment institutions. The majority of bonds outstanding simply do not trade. This is related to benchmark status. This is well recognised by institutional investors who will deliberately and regularly “roll” into a newly issued benchmark bond (out of the previous

benchmark) at a loss of yield[1], precisely to maintain a portion of the portfolio fully liquid, in the conscious knowledge that most of the rest of the portfolio will not be nearly as liquid, particularly if that liquidity is suddenly required.

Contrary to the assertion in 5.1.1 para 2, there really is no natural demand for two way prices from institutional investors; at any point in time the investor is usually either a buyer or seller. Even as an indication of the negotiability of execution price, the demand for a firm two way price is an expression of distrust.

Concentration in markets can be an issue, through its potential action on reputation. In a highly diverse market place, reputation is a key element for demonstrating trustworthiness. However, in a concentrated market with just a handful of traders, this need no longer hold true since those dissatisfied with the performance and integrity of one dealer have a limited choice of other counterparts, and even these have similar incentives with respect to their reputation. If the rewards are high enough, it may make economic sense to abuse a counterpart within the limits of the law, even if this destroys reputation.

We would also make the point that, other than for frequent repeat borrowers such as the sovereigns and the multilateral development banks and a relatively small number of others, the market price performance of any bond is largely immaterial. It is notable that since the crisis, though secondary markets have seen significant declines in dealer inventories and by some accounts declines in turnover, the bond markets have been used to raise unprecedented amounts of capital for corporates and others; the primary economic role of these markets has been fulfilled.

Chapter 1: Introduction

Questions of market abuse have always plagued markets. The thing that is different about the recent sets of scandals is that they involved mainstream participants rather than the peripheral and less reputable. In addition they involved a much greater degree of collusion than usual, both within institutions (largely banks) and between them. We believe that this is a question of the changed culture of investment banking/trading, to which we will revert later.

There is possibly a role for markets standards bodies consisting of the users of particular market places, which could co-ordinate the responses of these users to market misconduct and abuse. These could not only investigate and determine complaints, but also censure and sanction miscreants outside of the legal and regulatory system. However, given the international nature of many FICC markets, the creation of such bodies would be far from trivial.

Chapter 2: Key Characteristics

Section 2.1 paragraph 4

There are also fundamental questions of the credit-worthiness of counterparties in OTC systems, which will restrict access to these markets. While these may be overcome by central clearing, it is not clear that the costs of such arrangements are less than the costs of credit analysis currently incurred.

[1] See below: p. 4 (on Chapter 2, Section 6)

The question of internalisation is and always was central to the market making business model; the profitability of market makers comes principally from the crossing of instruments held for relatively short periods of time. Internalisation by a trader that does not make markets can be viewed as detrimental to the price formation function offered by market makers, lowering the quality of these prices.

Section 5

While the economic functions described are undoubtedly extremely valuable, we wonder how much of the activity in markets is really necessary to achieve these functions efficiently and indeed if the level of activity we observe does not lower efficiency currently. We note that, post crisis, secondary market trading liquidity in corporate bonds has declined markedly while issuance has increased significantly.

Section 6

The question of liquidity is very much double edged. It should be understood that liquidity has a cost; if it did not all assets could (would, in theory) be perfectly liquid. Concentration of activity in large benchmark issues is economically attractive to debt management offices precisely because it capitalises on the cost by issuing bonds at lower yields than might otherwise be achieved. It is also notable that in the immediate post crisis period debt management offices broadly adopted opportunistic strategies which did not follow this semi-commoditisation approach to fund raising[2]. It is worth noting here that most bond issues are not expected to be very liquid: they are purchased because of the predictability of both level and timing of their cashflows. Intrinsic liquidity is a very secondary feature for most bonds, if only because it is costly.

Box 2

As noted earlier, the description of market making here really only applies in the forex markets for major currencies and some government markets. It should also be noted that much other pricing is done parametrically on demand and based upon prices/yields, credit and liquidity spreads etc. in these markets.

The idea implicit in much of this discussion is that at any time there should only be one price. While a fundament of the traditional economic theory of equilibrium, it has never applied in practice; even in the days exchange-based markets jobbers would quote, and trade in different prices at intrinsically similar times. It should also not be forgotten that a dealer may use a price quotation to reveal information; for example quoting a high price which is not acted upon may reveal a potential buyer of the security.

The box is correct in noting that the principal to principal nature of OTC markets admits the possibility of abuse. Indeed, it was precisely these concerns among some market participants at the time of “Big Bang” that led to the formation of the Institute of Business Ethics.

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[2] See New challenges in the use of government debt issuance procedures, techniques and policies in OECD markets - Blommenstein - OECD 2009

As we see it, the key issue with electronic systems for trading is that they do not facilitate negotiation or build upon the trust that is central to execution of more unusual or complex transactions. We would also note that the proliferation of order types in many electronic systems, including some stock exchange systems, has opened entirely new possibilities for abuse and misrepresentation of markets.

Regulation

It seems to us that regulation must allow markets to evolve and develop if they are to perform their economic functions well; it is not at all obvious to us that the developments in progress, particularly in respect of capital markets union, share this objective or will have this effect.

Chapter 3: Fairness and Effectiveness

Table C Proposed characteristics of 'fair and effective' FICC markets

'Effective'

Enabling investment, funding and risk transfer; underpinned by robust infrastructure

Our concern with this element is that much trading activity does not serve any of these purposes; indeed, in many financial markets, trading activity is predominantly speculative in nature.

Competitive prices

We have some difficulty with this concept in the context of effective markets; such as: what is the counterfactual to the price at which a transaction was executed.

'Fair'

Clear standards of market practice

We are in complete agreement. The question as we see it is one of definition, ex ante.

Transparency

This has become something of a regulatory panacea, when the reality is that some transparency can be detrimental both privately and publicly. The question is one of degree and careful thought is needed on detailed design of the requirements. It should also be recognised that transparency resolves only a limited set of the difficulties we have observed.

Open access

This is fundamentally problematic. Surely denial of access is one of the most appropriate sanctions for those lacking in integrity?

Competition on the basis of merit

Here we agree but would note that in a relationship of trust this merit may not simply be related to execution or price services.

Integrity

Here we completely agree.

Section 3.2 Defining 'effective'

Paragraph 5

The role of speculators, who are not end-users in the economic sense described here, is worth some further thought. Their provision of liquidity to these other users is, to an extent, positive, but their activities may also reduce the value of prices as sources of information. A perfect example here is the FX market, which has little flow underpinned by real mercantile transactions or non-financial

investment relative to its extremely high turnover, and which is consequently dominated by noise obscuring the real price signal.

Paragraph 6
In many financial markets, prices simply do not reflect supply and demand. Indeed, in the corporate bond markets, parametric pricing[3] is used precisely for these reasons. The seasoning of securities and such things as the loss of benchmark status are very important in this regard, since they both indicate a loss of intrinsic liquidity.

Paragraph 8
We agree with the description of desired transparency as being sufficient for the verification of stewardship, and note that this is an issue both pre and post trade in MiFID 2.

Paragraph 9
It seems to us that there are two dimensions to access not discussed. There is the question of access to acquiring the status of market maker (where this is privileged or recognised) or trader, and there is the question of access to these market makers and traders for end users and other participants.

Paragraph 11
We are pleased by the explicit reference to agency activity; particularly as much such activity is booked as principal trading.

Section 3.4 Can there be trade-offs between fairness and effectiveness?

We find the fragmentation of liquidity arguments unconvincing. However, it is clear that a dealer taking a large position into inventory should have regard to the speed with which this transaction will become known to the broad market: a transparency issue. However, the chances are that many of its competitors would already be aware that such a transaction was abroad.

The competition issue as we see it is one of the dependence of end users upon trading firms and their quoted prices.

Chapter 4: Evaluating the fairness and effectiveness of FICC markets

Box 4 The importance of market liquidity.
As we see it, liquidity is a much misunderstood subject. We wonder how many buy-side participants would really be calling for ever more market liquidity if they realised it had a cost to them even if it is not utilised. We have taken the various prudential reform packages as given in our responses. Of course, we do have reservations about many of the changes, including liquidity. This, though, is liquidity in a far broader sense than merely market liquidity. We feel that our central banks should be actively monitoring the degree of liquidity in the various market segments and the degree to which the flows of liquidity <u>between</u> these segments is facilitating activity.

[3] Parametric pricing equates the present value of closely equivalent (and therefore practically fungible) cashflows from different bonds, one of whose price is reasonably certain.

We would repeat that vast swathes of outstanding bonds are intended to be held to maturity, as matching existing liabilities or merely as savings instruments. For such holders the cost of additional liquidity is not one they particularly wish to bear. Indeed so-called private placements are expected to yield more because explicitly illiquid, and are much favoured by "buy to hold" investors. For these holders information which may be price relevant but unrelated to the fundamental probability of receiving the coupons and principal as contracted is largely redundant.

We do feel that the principal question here that has not been addressed is: how much market liquidity is really necessary to ensure that the desired economic functions are generally well served? And how much additional "emergency" liquidity may be required as a buffer in times of stress?

Q2: Of the six themes identified in Table A on page 5 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?

From our perspective, the abuses and misbehaviour obviously fall under the rubric of personal and institutional conduct and are thus questions of governance and incentives rather than of market design. This view has found expression as questions of culture in investment banking. We feel that it should be recognised in a broader context. This is the question of the dogma of shareholder primacy, which leads to alignment of the financial interests of shareholders and management, to the detriment of all other stakeholders. This primacy approach is embedded in the FRC's corporate governance codes and of course, has a legion of vested interests which can be expected to support it. The role of this misplaced primacy is paramount in forming the incentives both to take unwarranted (and frequently ill-understood) risk and to skirt if not cross the boundaries of laws, regulation and decent behaviour.

We are not sure that there are any deficiencies that require active intervention, other than those concerned with conduct and market abuse. Further given the volume of change in train, we would like to observe the effects of these changes before embarking on anything new.

Chapter 5 Specific issues in FICC markets

Paragraphs 7 & 8

We have heard proposals to "standardise" corporate bond issuance on numerous previous occasions. To date all such proposals have failed. We do not believe that it is either desirable or ultimately feasible. Surely, if there were benefits, such practices would have evolved already; it is not as if there is any shortage of corporate financiers and investment bankers looking for an innovative edge.

These proposals often include standardisation of terms such as covenants and warranties. While some minimum standards may be desirable, these are critical issues in pricing and security which are borrower specific, and often even idiosyncratic to specific issues from the borrower. Rather than lowering the costs of borrowing by bond issuance, we believe that standardisation would raise it. The creation of standards will inevitably lead to forms of basis risk, as it so obviously does in futures markets already.

Paragraphs 9, 10 & 11

There can be no doubt that some institutions do receive favoured treatment from arranging banks. These are usually the institutions where the relations of trust that are critical to well functioning OTC markets are strongest. Individual investors do receive higher allocations in weakly subscribed issues. However, they have subscribed to these, and usually more. The only grounds for complaint here would arise if the book-running institution were to have misled the market as to the state of demand.

The issuer's objectives are paramount in this, and as noted, there are ICMA guidelines[4].

Publication of final allocations would risk breaching the confidentiality of transactions, and achieve little if it were of the generic insurance company, pension fund, or individual type. Almost all auction type distribution processes seem unlikely to add value or reduce costs. If awards were to be made at the bids submitted then complaints would likely arise that larger institutions were better informed. It should be recognised that the syndication or distribution processes that are in effect are the result of many generations of trial and error. Take the rather extreme example of disclosing both institution and bid price under a system of allocation at the price bid at the end of the distribution period: this would leave the institution exposed to gaming behaviour by all others. It should be remembered that a great range of methods of distribution has been tried, but are no longer current practice: the bought deal is a good example.

Q3: Do trading practices involving barrier or digital options pose risks to the fairness and effectiveness of one or more FICC markets?

No. There is nothing unfair about buying or selling any security in the hope of influencing its subsequent price action. The counterpart to the transaction is free to act in opposition.

How hard is it to distinguish between hedging and 'defending' such options in practice?

Such classifications are intrinsically subjective.

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?

No

Q5: Is greater use of electronic trading venues for a wider range of market participants possible or desirable?

It is undoubtedly possible to move to a greater use of electronic trading systems but the desirability of this is highly suspect. The issue of the development of trust noted earlier is one aspect. There is also an implicit assumption that trading activity is exogenously determined: it isn't. Many transactions are generated as ideas that suit a particular dealer's trading book and an investor. The orders need not be best execution in the sense of the highest bid and lowest offer; the investor in this case is nonetheless benefitting from activity that makes sense for them.

Are there barriers preventing a shift to a more transparent market structure?

In the absence of clear evidence to the contrary, we are not convinced that a more transparent bond market is either more effective or more fair. What barriers there are, are predominantly technological in nature but the more important issue is that there are real and valid objections to greater transparency. For example, exposure of trading activity could be exploited by other participants.

It might be worthwhile to perform a gedankenexperiment in this regard, which would be to ask how far would we want transparency to go in the pursuit of clearer pricing of admittedly illiquid bonds. Taking it to a possible pathological extreme should we ask for the names and addresses of the

[4] There are guidelines in other markets too: eg. Canada

institutions involved to be reported; or that of the traders? Transparency obviously has a limit. It is fair to say that that limit is reached when all parametric information required to price a bond that has not traded recently is easily available. Beyond static data describing the bond, and readily available price data regarding the liquid benchmark all we need is round-lot price reporting of similar issues that have actually traded recently. It should be understood that standard prices made by market makers are indeed for round lots, and that other trading sizes, whether much larger or much smaller are subject to negotiation.

On the other hand, and notwithstanding our view that there is no convincing argument for additional transparency in bond markets, we know of no technological impediment preventing a shift to more transparency within markets.

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?
Not at this time.

5.2 Competition and market discipline

5.2.1

Paragraph 1 Our concern is that market discipline in this sense of moving business to other dealers may prove impractical in those areas which are concentrated. This is largely a question of the diminished importance of reputation. Transparency with respect to disputes may in fact help in this regard.

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?

Market discipline as described in this review is unlikely to have much effect. If any investor counterparty to a dealer ceases trading with them, this is unlikely to be material. Only if disputes and such cessations become public knowledge are they likely to give rise to concern to and with that trader.

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?

The competition framework is irrelevant at the level of the individual employee, but the firm should certainly be aware of it. This is relevant in the context of bundled services, where some firms will not provide services in one area unless services in other areas are also used. The classic here is: I won't trade with you in French OATs unless you also deal with me in German Bunds.

Q21: Do current domestic and international initiatives by industry and regulators to improve the robustness of benchmarks go far enough, or are further measures required?

Probably, as for further measures, let's wait and see.

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

The use of and reliance upon benchmarks by asset managers and other investors may well be excessive but that does not mean any steps should be taken to reduce it. This has no direct effect upon the fairness or effectiveness of financial markets.

Box 6 Conflicts of interest and information flows

There are real issues with contractual terms that limit the scope of applicability of the concept of fiduciary responsibility; these range from the disputes arising in the wake of the recent Swiss franc realignment to the far longer standing ability of fund managers to contract out many of the responsibilities arising. This is often confused by the fact that transactions executed as agent are booked as principal to principal, and often expressed as net prices. We do not believe that voluntary codes of conduct will influence this behaviour.

The recent Law Commission report[5] is not helpful in this regard as it suggests that private law can and should substitute for further explicit statutory law, we note that only a very small handful of disputes ever reach the courts. Moreover, for smaller participants the cost of private legal action is often prohibitive.

We note (and rather like) the Department of Business Innovation and Skills' response to the Law Commission Review[6] which contains the following:

"All participants in the equity investment chain should act:

- *in good faith;*
- *in the best long-term interests of their clients or beneficiaries;*
- *in line with generally prevailing standards of decent behaviour.*

This means ensuring the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.

These obligations should be independent of the classification of the client.

***They should not be contractually overridden**."* (emphasis added)

Conflicts of interest are, of course, inevitable. The recent National Audit Office publication on conflicts of interest notes this:

A principles-based system assumes people will act honestly and volunteer information about conflicts and exclude themselves from decision-making where they exist. But there should also be prompts and checks to reinforce this particularly where the risk of conflicts of interest is high. Preventative measures need to be supported by proportionate mechanisms to detect non-compliance and sanction where appropriate.

There should be management, internal controls and independent oversight to detect breaches of policy. Such controls may include:

• external oversight arrangements – for example, independent assurance that conflicts are appropriately managed and arrangements for detecting breaches such as external audit and regulator checks; and

We believe that there should be an explicit audit requirement for compliance. We would suggest that random audits by the relevant regulator or their appointee should be sufficient in this regard.

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[5] Law Commission - 30 June 2014 - Fiduciary Duties of Investment Intermediaries - Law Com 350

[6] Law Commission - 2013 - Fiduciary Duties of Investment Intermediaries Consultation Review 215 §1.10

- *a reporting system, such as whistleblowing arrangements for staff to raise concerns*.

We have a recurrent concern that whistleblowers are usually ignored and frequently punished for their actions. We would also note that the duty of loyalty of an employee to her employer is an important ingredient in avoiding the formation of internal and external cliques and teams.

In cases of non-compliance, there should be a system of proportionate, enforceable sanctions that include personal consequences (such as disciplinary action, dismissal or prosecution) and management actions (for example, retroactive cancellation of a decision or contract).

We would note that private law would be a very weak environment in which to apply or enforce sanctions. Given the personal nature of many conflicts, and the fact that an individual employee may be unavailable to, or indemnified against client action, we believe that the sanction process should be regulatory in nature.

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?

We have significant reservations over the effectiveness of market discipline – indeed, we do believe that, in the form of shareholder primacy and empowerment, it lacks even theoretical support. It is notable that in their empirical paper: Shareholder Empowerment and Bank Bail-outs Ferreira et all offer evidence that contradicts the idea of shareholders (and implicitly share prices) disciplining the board or management.

In the form involved in this consultation, the market discipline is to be applied by clients. This makes it imperative that there should be a choice of other suppliers of the service and that transfer costs, where applicable, should be minimal. Many rules currently make even the opening of a simple bank account a lengthy process. The other point to note is that clients will have suffered at the least some disappointment if not actual disillusionment, and that will have an effect on generalised trust. There is also a significant asymmetry of information here. We do believe that disclosure or transparency is an appropriate and effective remedy for these problems. If a fund manager were required to disclose all disputes and the prior settlements reached, this would inform both current and potential clients. We think that similar disclosure rules could be applied in other markets – the question is one of boundaries. It would in our opinion be nonsensical and completely disproportionate to require disclosure that "we quoted 599 times and traded just once in one million bonds".

By far the largest reliance on benchmarks stems from instruments themselves rather than from mandates to investors and asset managers. For example instruments linked to LIBOR are estimated to total from over $300 Trillion[7] to $800 Trillion[8]. In comparison, global funds under management were estimated to be a mere $67 Trillion in 2013[9], expected by some to rise to $100 Trillion by 2020[10]. Furthermore mandates for investors/asset managers managing non-money market portfolios (e.g. with average or maximum maturities of over 2 years) have benchmarks containing hundreds if not thousands of component securities. These indices are more and more frequently priced by numerous price sources. This is sharp contrast to LIBOR indices, priced by a group of eight banks drawn from a pool of sixteen. It is several orders of magnitude harder to influence the level of a bond benchmark than it is to do so for LIBOR.

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[7] Hou,David and Skeie,David - March 2014 - LIBOR: Origins, Economics, Crisis, Scandal, and Reform - Federal Reserve Bank of New York Staff Report No. 667, p.2

[8] Wall Street Journal September 21, 2013

[9] http://www.statista.com/statistics/323928/global-assets-under-management/

[10] PwC Report : Asset Management in 2020: A Brave New World

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

While it is clearly desirable in many circumstances to reduce the dependence upon benchmarks, for example, between pension funds and their investment managers, we are far from convinced that any action should be based within fair and effective markets. We do see the manner in which investors choose to manage, or have managed, their assets as a matter of private preference.

It should be noted that from a practical point of view benchmarks consisting of bond indices are intrinsically extremely difficult to manipulate in a way that is likely to have an effect on asset managers or other investors . This is not simply because bond indices are comprised of very many constituents. There are three further safeguards. First, investors using the benchmark are extremely efficient at spotting and questioning any oddity or seeming deviation and in informing the index producer of such. Second, even if the investor is totally passive the benchmark can only be realistically replicated parametrically: no one owns each of the thousands of bonds in any broad index, nor even the hundreds in a narrow index. As such, index tracking explicitly recognises the likelihood of tracking error, the permissible level of which is usually mandated within the fund management contract. Third, funds that are not passive, but instead aim to outperform the index, will attempt to do so using clear strategies which are explicitly designed to be different from the index in specific parametric dimensions (e.g. longer in duration than the index, or shorter in convexity, or underweight in senior bank bonds etc.). In other words, they can only outperform the index by being different from the index in very conscious areas that express the fund managers' view regarding the evolution of that dimension. This means that in every other dimension they are still trying to replicate the index parametrically with a minimum of tracking error, but also with a minimum of holdings. Thus clients using the index are highly unlikely to be affected by any (also highly unlikely) manipulation of the underlyings, which enterprise would be extremely difficult to undertake successfully.

Thus in addition to our argument that the choice of a benchmark or not is a matter of private preference, we would also argue that the extremely unlikely possibility that an extremely complex manipulation of a bond index benchmark is outweighed by the practical uses of such benchmarks in performance measurement and attribution by at least two orders of magnitude.

Box 7 Reported uncertainties over FICC market practices

Distinction between legitimate trading activity and market manipulation

We do not see anything inappropriate about a dealer or investor trading with a specific price objective in mind. These are transactions that may be countered freely. The question of manipulation is one where prices do not reflect executable opportunity – for example: quoting high prices but refusing to buy at these prices, or buying substantial amounts of a particular security in order to corner it – typically this would involve restricting the supply of borrowable securities.

Standards for external communication of market activity

The greater problem is that many such colour reports mislead or repeat hearsay without describing it as such. Restricting such colour to information known to the supplier of the colour or information that is independently verifiable should resolve most difficulties here. This may amount to no more than publishing "the market rumour is that PQR securities has been a big buyer" rather than "PQR securities is a big buyer".

Standards for internal communication of market activity

It is clear to us that information related to transactions undertaken as agent should not be shared with a principal trading desk.

Lack of granular market-wide standards for client suitability

We should not lose sight of the fact that many clients wish to be treated as professional investors as they perceive the gains associated with this level of access to outweigh the protections as retail clients forgone. Provided the dealer explicitly draws attention to these differences, we see this as acceptable. It is clear that to have these elements buried deep in the small print of a contract is not acceptable.

5.5 Responsibilities, governance and incentives

We do believe that wider performance measures for individuals are needed. We would caution though that the 'hire and fire' management mentality introduced with Big Bang was instrumental in lowering the perception of the duty of loyalty of employees to the firm. Simply put, we should not be surprised if teams feel more loyalty to other members of their team than the firm that employs them all. Under "hire and fire" it is to be expected that individuals may feel well-advised to develop strong relations with personnel in other firms in the market, as these firms are likely to be future employers. This is a marked shift from markets in which strong relations with clients were the dominant concern and strong loyalty from a firm to its employees the norm.

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

Shifting business among traders is likely to prove costly. Reporting and public disclosure of those reports is much more likely to produce the desired results.

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