European Financial Forum 2017 Policy Summit

Cumberland Lodge, Windsor Great Park

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Remarks by Mark Yallop, Chair of FICC Markets Standards Board

Good afternoon

Thank you for this opportunity to talk about the FICC Markets Standards Board, or FMSB. In the next 15 minutes or so I will try to cover three topics:

1. What is the FMSB?
2. What are we trying to achieve and what will be different as a result of our work?
3. What are the biggest concerns we have for the future of wholesale fixed income markets?

What is FMSB?

FMSB was established as a result of the Fair and Effective Markets Review as a private sector, global Standard setting organisation for the wholesale fixed income, currency and commodities markets.

Our sole purpose is to identify areas where day-to-day practice in wholesale markets is unclear or ambiguous; to develop Standards which guide market participants in simple, practical ways on how to react in those circumstances so that market users get the best and clearest outcomes possible; and to have those Standards adopted as widely as possible across global FICC markets.

We have 50 Members who provide knowledge, funding and commitment from the highest levels of their senior management. About half our Members are banks and half non-banks – including major corporations, asset managers, hedge funds, exchanges, clearing houses, electronic trading platforms, brokers and data providers.

Those Members account for at least 80% of all activity in wholesale FICC markets worldwide, over $10 trillion in assets under management, over $100 trillion in custody and administration assets, over $100 billion in corporate new issue volumes in the past year, 60% of global inter-dealer broker volumes and a very large share of exchange traded volumes.

They have made available about 200 expert executives to help with identifying where Standards are needed and developing the Standards themselves.

Last year we published 5 Standards; this year we are aiming to publish a further 10. We have identified about 75 topics on which we expect to publish Standards over the next 3 years or so. To give you a sense of the breadth of our work we currently have Standards in preparation on government bond auctions, information sharing across markets, governance of algorithmic trading, resolution of trading errors, risk management transactions attached to new issues and first lines of defence structures among other topics.

This is a unique project: never before has anyone tried to bring together all sides of the wholesale markets – market makers and price takers, issuers and investors, banks and corporates and asset managers – to address how markets should work.

Two important points to emphasise:

- we are not a trade association or representing narrow industry "interests" and we are prohibited by our constitution from lobbying;
- FMSB has no enforcement powers or legally-binding authority: we have no power to compel our members to work with us and we are not a "self-regulator".

So this is self-determination in action: the wholesale market taking responsibility itself for fixing the serious problems revealed in recent years, rather than relying on regulators to tell it how to behave; and in so doing trying to re-establish market discipline.

For reasons we can talk about later, all these factors give FMSB a much better chance of addressing real problems, and changing behavior in markets, than anything tried before.

There are two important limitations on our scope:

- we are not addressing retail financial markets or products;
- we are not – at least at present – trying to tackle problems in the equity markets.

What do we want to achieve and what will be different as a result of FMSB?

We are trying to address, at their root, the causes of the misconduct problems that have featured repeatedly since the dawn of modern capital markets and to create fair and effective markets that deliver the best outcomes for market users.

Right now, the DoJ is investigating manipulation of the US Treasury market. But the earliest efforts to manipulate that market date from 1792 when the then Assistant Secretary to the US Treasury – and, it turned out, the first of the great insider traders of the modern era - was helped by a group of unscrupulous bankers in an attempt to

corner the market. In the 225 years since then there have been numerous well publicised squeezes, cornering, crashes and other problems.

The SEC and the FCA are today looking at abuses of markets by electronic trading engines. But French bond prices traded on the Bordeaux exchange were being manipulated by traders who found a way to interfere with the telegraph system that transmitted prices from the Paris bourse back in 1834. Network abuses are as old as networks.

We have made a study of market abuse in the 20 largest jurisdictions over the past 235 years and will shortly be publishing a summary of our findings and of what we believe are the 25 commonly occurring "root causes" of market abuse. These practices repeat over and over again across markets and time: it is an uncomfortable, but observable, fact that regulation and new laws have not prevented the problem.

As an aside, we shouldn't be surprised that laws and regulation don't fix the problem. The roots of the behaviours that drive misconduct lie deep in philosophy, psychology, social science, genetics and neuroscience - all well outside the regulatory perimeter.

We aren't arguing that regulation is unnecessary or bad; good regulation is a <u>necessary</u> pre-condition for markets to operate credibly and safely. But good regulation and a strong legal framework are <u>not sufficient</u> to ensure fair and effective markets.

One of the biggest problems is that regulation tells wholesale markets very little about how to operate. Many wholesale markets are not regulated at all. And in those that are regulated there is a big gap – we call it the "conduct void" – between the high-level principles that the FCA and other regulators publish and the detailed rule books.

In this gap, multiple views develop about how participants should treat each other. These do not foster fair or effective markets.

What is needed as well as regulation is guidance that tells market participants how to operate in practical ways when they encounter ambiguous circumstances, for example:

- I sold a barrier option to my client. Now the market is approaching the knock-out/knock-in. Can I buy/sell to over/under-hedge my position (and thereby impact the likelihood of the barrier being reached, or not)?
- I'm syndicating a new bond issue for my client: what should my secondary trading desk be allowed to do to hedge its contingent risk that they will end up owning bonds?
- I'm an issuer: how much control should I have over who my bonds are distributed to? How would I like the reference yield for my deal to be chosen?

There is nothing in regulation which tells anyone how to answer these questions, and yet they cause confusion and frustration every day in markets.

But Standards, developed jointly by market participants who understand how markets actually work, can address these questions; and FMSB can provide those Standards.

Over time I hope the impact of our work will be profound and global, not just here in the UK.

At a simple level I hope that adherence to FMSB Standards will become the norm for the bulk of wholesale FICC markets activity worldwide, alongside compliance with local regulation as is expected today.

I hope that market participants who are not FMSB members will appreciate the value of FMSB Standards and want to do business using our Standards, spreading the relevance of this work much more widely than just our 50 Members and their clients.

But at a more profound level I hope that this initiative restores the "market discipline" which is missing today.

A lot of people fret about rebuilding trust in financial services. But I think the question is not "how do we restore trust" but rather "how do we make it easier to judge trustworthiness".

Unfortunately, we live in a world where people who are determined to be untrustworthy will always look for ways to conceal their trickery. What the rest of us need are tools to be able to interrogate our counterparties more thoroughly and to place our trust intelligently, where the evidence shows that this is justified.

And the real challenge today, as I have suggested, is not for regulators, but for market participants. How do they change the way they operate and make it easier for others to judge their trustworthiness?

FMSB is the vehicle for wholesale market participants to take responsibility themselves for fixing problems that have been uncovered; for them to find credible, granular ways to define what will be done differently in future; and to publish how they are doing that.

FMSB will help us get to a position when market practitioners have the means and incentives themselves to police fair and effective markets and the best outcomes for users of markets; and individuals and institutions in positions of knowledge, power and influence in markets use their advantages in a professional way to ensure the best outcomes for users of markets.

We need to remind ourselves that there is no conflict between fair markets and commercial returns: fair and effective markets will be more attractive places to do business, will trade in higher volumes and be more profitable than markets which are, or are suspected to be, abused.

I think this will be especially relevant for UK-based markets in a post-Brexit world; we might talk more about this later.

Some future challenges for the future

Notwithstanding the important lessons we can learn from historical research, our Members are more interested in the future than the past. So let me touch on three areas that we think are genuinely problematic about markets right now.

First, "conduct anxiety".

We know that one intended consequence of regulation after the crisis was that tougher rules would prick the bubble of speculative trading activity, particularly by tax-payer insured banks.

But there is evidence that the reductions in market liquidity over the past 8 years, have exceeded what was intended in the regulatory clamp-down after the 2008 crisis, and that which would be expected as a logical result of the tougher prudential capital and liquidity rules.

Conduct anxiety is one important explanation of this observation. When institutions come to fear that their actions today may be reinterpreted in future with 20/20 hindsight, then they often conclude that it is just more prudent not to trade today.

Unfortunately, the poorer liquidity that results hurts market users and makes markets less fair and less effective for those who need them most.

The cost of this to market users in the real economy, whether it is caused by mis-calibrated regulation or by conduct anxiety, needs more thought than it has been given so far.

Second, regulatory fragmentation.

This topic is much discussed, but rarely though the lens of whether markets are fair and effective for users.

Lawmakers and regulators across the key financial market jurisdictions have taken a variety of paths, at different speeds, following the global financial crisis, with policy

imperatives sometimes trumping a thorough analysis of foreseeable, undesirable market consequences.

Some of these regulatory initiatives have fragmented liquidity, increased the costs and impaired the effectiveness of markets for end users.

US regulation, for example, has fragmented swap market liquidity, both domestically in the US and internationally between the US and Europe, to the detriment of all.

As Chris Giancarlo, the newly appointed Chairman of the CFTC has said: "*Flawed and ill-suited swaps market regulation arbitrarily increases the cost of risk management, repels global capital, diminishes trading liquidity and stymies the legitimate use of derivatives causing the economy as a whole to suffer*".

The recent discussions about a location policy for euro clearing, the divergences between SEC and MiFiD rules for research and the impact of a payments moratorium in Europe on global derivatives close-out rules are just three other examples.

Ultimately it is the users of wholesale markets in the wider economy who bear the cost of unfair and ineffective markets. But they also pay the price if the measures taken to improve fairness and effectiveness are themselves ineffective or extremely inefficient.

More debate is needed about where the right balance lies between the costs and benefits of measures intended to protect the interests of market users, and the liquidity, cost and efficiency impact of those measures on the markets that users need to access.

Third, the unintended consequences of the "electronification" of fixed income markets.

Electronic trading received a major boost in the past 10 years from the G20 regulatory reforms and it has delivered benefits, including improved transparency and auditability.

But electronic trading does not eliminate market abuse and misconduct - these cannot simply be "coded out" - and it can create new types of vulnerability for fixed income market users, often in subtle ways, to give you just four simple examples:

- The commercial incentives and rebate structures for liquidity providers, and the platform rules about who can see market indications of interest, bids/offers and executed orders are often complex, normally invisible to market users; but can impact pricing and liquidity and the fairness effectiveness of markets for users;

- The rules that match bids and offers in the order book favour certain types of trader - often the faster ones - and frequently create opportunities for electronic versions of the flash orders, spoofing, manipulation of closing market prices and other abusive techniques that are seen in traditional voice markets. Opportunities

for market makers to review a price before a deal closes - the "last look" - also perpetuate unfairness seen in traditional markets;

- Electronic markets proliferate new order types, allowing for example: conditionality in the execution of an order, follow-on trading after an order has been filled, queue jumping, the shielding of larger overall orders from lit markets - all of which tilt the playing field against market users in ways that are not clear to many, if any, of them;

- The electronic "dark pools" in which selected participants trade with other privileged participants outside the glare of public "lit" markets fragment liquidity to the disadvantage some types of market user.

Conclusions

History tells us that misconduct has been a repeating problem over a long time.

Experience tells us that it has complex root causes.

Logic tells us that regulation cannot be the answer.

But lack of clear guidance about how business should be conducted is without question one major contributor. The FMSB initiative has the capability to solve that problem and be a decisive step on the journey to rebuild trust in markets.

Ladies and gentlemen, thank you for your attention.