Asian Fixed Income Leaders' Summit

How can buy and sell side collaboration be brought forward to promote standards in Wholesale Markets?

Remarks by Mark Yallop, Chair of FICC Markets Standards Board

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Good morning

It is a pleasure to be here with you today.

Busting some Myths

You can't open a newspaper, or turn on television at the moment, without being reminded that we are passing the 10th anniversary of the global financial crisis.

There are many myths about the crisis and its causes.

For example: the manipulation of markets that came to light was a one-off; that the regulators are fixing it so that won't happen again; or that forcing markets to trade electronically will make sure that stuff never happens again.

Unfortunately, all these three myths are just that: myths.

Let me share some truths with you.

First: manipulation of markets has been happening for a very long time.

In 1792 - just 16 years after the US achieved Independence, William Duer - who was Assistant Secretary to the US Treasury, and 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 then infant market in US Treasury bonds. He came unstuck, but only after several months of profitable manipulation.

In 1814, a group of conspirators in England succeeded in ramping UK gilt market prices by 20% in one morning by spreading false rumours about the end of the Napoleonic wars. They were found out and sent to prison.

In 1834, two clever French bankers succeeded in hacking into the first government telegraph system to distort the prices of government bonds trading in Bordeaux, and were able to continue to do this for two years before they were caught and expelled from France.

And manipulation is certainly not restricted to government bond markets.

In the past two centuries, there have been many thousands of cases brought by enforcement authorities globally for wholesale market manipulation and misconduct in virtually every corner of the fixed income, currency, commodities, equity, cash and derivatives markets.

Second: the continuous efforts by lawmakers and regulators over this period to address manipulation and misconduct have not been effective in their goal.

Tens of thousands of pages of law and regulation have been promulgated. Legal frameworks have adapted and markets and trading techniques have evolved, but misconduct has proven to be extremely resilient.

Third: misconduct and manipulation is not <u>prevented</u> by electronic trading.

As we know from equity markets, e-trading brings many advantages: more open market structure, new market participants, improved transparency and auditability, and lower cost of execution. But, in the hands of miscreants, it can still leave open opportunities for age-old market deceptions - and create opportunities for wholly new types of manipulation.

Fourth: the financial cost of market manipulation has been staggering.

Ignoring the costs to market users who were defrauded, the fines alone imposed over the past 6 years on banks globally amount to $375 billion, about 80% of which related to wholesale markets. If that money had been retained as capital it would have supported $5 trillion in bank lending to the real economy.

But **fifth**, and this is perhaps the most important, the real injury that manipulation has inflicted is the systemic damage to trust in financial services and the erosion of the social licence that banks and others in the financial system need to operate.

The cost of this damage, in lower revenues, permanently higher costs, higher taxation, market structure changes, higher cost of capital and loss of influence have yet to be calculated - if indeed it ever can be fully analysed.

If a huge and sustained regulatory and legislative effort has failed to stop repeated examples of misconduct, then we clearly have to try something else. But before I address that, it is worth spending a moment on why regulators and legislators have been frustrated in their mission.

Why has legislation and regulation failed to stop the problem?

A good legal framework and good conduct regulation are essential pre-requisites for well-functioning, fair and efficient markets.

But even good regulation faces some severe challenges.

It's hard for (largely) jurisdictionally-aligned regulation to control global markets in which liquidity doesn't recognise national borders.

It's hard for regulators to track the pace of new product and market development in global markets, particularly with the rapid development of derivatives and increasing volumes of very high speed business being done electronically.

High level regulations – the guiding principles of the sort that many conduct regulators publish – have to be set out in such general terms – "act with due skill care and diligence" – that they can't tell those in markets how to act in ambiguous circumstances.

Low level regulations – the rule books that all conduct regulators publish – are very operational and don't describe how to resolve tricky conflicts that arise every day in markets.

Consider the very simple case of a new bond issue, and the interests of the five parties involved: issuer, investors, the syndicate desk, the secondary trading desk at the lead manager and the derivatives desk swapping the proceeds either for issuer or the investors.

These five all have different economic interests from each other.

The issuer would like the issue priced tight to the reference security while the investor, and the secondary trading desk, with an eye to owning the bonds in 30 days' time, would like it cheap.

The swap desk would like the swap priced tight to government bonds while the issuer would like the swap spread wider.

And this is before you consider other conflicts:

- who should get to decide how the bonds being issued will be allocated between different investors? Pro-rata based on potentially inflated demand? Preferentially to those favoured buy-side accounts of the lead manager who pay the lead manager big commissions on other business? Preferentially to the investors that the issuer favours? Some mix of the above?

- how much of what kind of information is it appropriate for the syndicate desk to share with potential investors and other market participants, informally or formally, ahead of the launch of the deal? What caveats should accompany this information?

- how should a reference rate for pricing the deal be determined, given the potential opportunity – virtual certainty even – that the syndicate desk, the secondary desk, the swap desks and the potential investors will <u>all</u> be trading that reference rate as well at the same time that the issue is being priced and distributed?

There is nothing in regulation that tells any of these five participants how to manage their conflicts of interest.

Between the high-level principles and the low-level rules there exists a "conduct void" in which acceptable market practise is unclear and a multiplicity of behaviours have developed – sometimes slanted to the detriment of market users and in some cases twisted to enrich particular players.

The conduct void, the series of high profile regulatory penalties that we have seen in the past decade, and the problems I have hinted at with exercising judgement, have combined to create a second problem which I have called "conduct anxiety": markets become less liquid if participants fear that their actions today will be judged with 20:20 hindsight according to some different set of rules tomorrow, and so simply don't trade today.

It is tempting to see regulation – more, and tighter, controls on markets - as the solution to the problems revealed in recent years. But the evidence of recurring problems over two centuries suggests that it hasn't been effective so far.

<u>Rather</u>, I believe we have to see formal regulation as a necessary, <u>but not sufficient</u>, condition for well-functioning, fair and effective markets.

Regulation can tell you what you mustn't do; it doesn't tell you how to do business (and nor would anyone in this room want to see regulation extended in such a direction).

To deliver fair and effective markets we need something more.

This “something more” is a set of Standards agreed between all market users which provide practical guidance on how conflicts that arise every day, in every wholesale market trading centre worldwide, should be handled so as to ensure fair outcomes for market users.

How can we deal with the problem? The role of FMSB

The FICC Markets Standards Board, which I chair, was established in late 2015 to provide a global platform for creating such Standards.

It was set up in the wake of the LIBOR and FX scandals – at a time when market users, market authorities, politicians and the public called time out: enough is enough - but it could just as easily have been prompted by many earlier incidents.

It brings together market users and market makers; issuers and investors; corporates and banks, hedge funds and non-bank liquidity providers; asset managers and exchanges, brokers and clearing houses from all key wholesale markets globally.

Today we have 50 Members who collectively represent 85% of sell-side activity in wholesale FICC markets globally, $10 trillion of global assets in the asset management industry, $100 trillion of global assets in the custody industry, over $100 billion of annual new issuance volume in the global debt markets, over 60% of all FICC trading globally in the inter-dealer broker markets and over 60% of European exchange traded and post trade activity in wholesale markets.

Several of our members are represented by the firms here today.

Such a representative cross-section of interested parties has never before been assembled – for any purpose, let alone to address market failure.

Our mission is very simple: to identify the grey areas where wholesale market practise is unclear, formal regulation can't help and market users are vulnerable – and to develop and publish Standards which lay out exactly how markets should function in these areas in order to deliver the best outcomes for all users.

We are a private sector body, practitioner-led, and practical; owned and operated by the major participants in wholesale markets, for the wholesale market.

We are focussed only on Standards production. We are not a regulator or a self-regulator, we have no enforcement powers, we are not a lobbying firm, trade association or advisor. We are not seeking to replace regulation or interpose ourselves between firms and their regulators. We are not trying to dictate or to measure culture in markets – though what we are doing will have I believe a profound impact on market culture over time.

We provide a forum for collective action to address problems that have in truth existed for some time but which is very hard, or impossible, for a single firm – or even group of firms - to address.

And all our Members undertake to adopt our Standards when they join FMSB, and evidence in a public statement each year that they are actually doing so and have allocated resources to make this happen.

London is the most systemically important, multi-currency trading location for wholesale FICC markets and is the logical place to develop such Standards. But we are developing international, and generally global, not just UK Standards.

The authorities have taken a bold step by allowing the industry a chance to take responsibility themselves for leading the process of fixing the problems that have been uncovered - and for demonstrating better outcomes for market users.

Over time our members will define in clear, granular ways, what will be done differently in future in markets.

And by publishing these Standards and the evidence that they are being followed, so that others can judge whether change is real, I believe we can take a profound and important step along the road to demonstrating trustworthiness – and in due course helping to rebuild the trust in markets that has been lost this last decade.

What is FMSB actually doing?

Last year we published 5 pieces of work covering an eclectic range of topics:

- binary options in the commodity markets;
- reference price transactions in rates markets;
- the new issue process for European capital markets;
- surveillance techniques for FX markets;
- training programmes for FICC staff.

Since then we scoped the range of conduct problems that need to be clarified.

These range from big, broad, strategic questions which affect all markets such as:

- how the protocols for electronic market order books should operate;
- the definition of the role of "agents" and "principals" in markets and how these differ;
- the dissemination of confidential "market colour" information to other market participants;

to highly specific questions, such as how government bond auctions should be conducted, or the right to a "last look" exercised by a market maker in foreign exchange.

We are now working on Standards relating to 10 additional areas including:

- risk management techniques for new issues;
- auction processes in government bond markets;

- information barriers in primary capital markets;
- confidential information sharing across secondary FICC markets;
- suspicious transaction monitoring in FICC markets
- governance of algo trading engines;
- rule books and handling outages in electronic markets;
- resolution of trading errors;
- commonly occurring abusive trading practises in FICC markets.

I expect that we will publish about 10-12 Standards before Christmas this year that by 2019 we will be well on the way to creating a comprehensive and coherent set of foundations to guide day today practice in wholesale markets.

Three things are fundamentally different about the FMSB from anything that has been tried before: it is a private sector body empowered by the authorities to take charge of improving user outcomes; it includes members from all sides of the industry; and it has a clear adherence mechanism.

These three facts give the FMSB a chance to succeed where previous initiatives have failed to get traction. And for these reasons, I am very confident we will be successful.

Indeed, if there had been a bit more of this in the past, we might have much less regulation today. But we shouldn't kid ourselves that regulators will just stand by if we fail to do a proper job: if credible, and effective, Standards are not developed, and soon, then regulators will fill the void in their own way.

So, while I am very confident of success, the stakes are also very high. If you would like to be involved in our work I am keen to talk to you today.

Ladies and Gentlemen, thank you for your attention.