Boston Fixed Income Leaders' Summit

Setting FICC Markets Standards: 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.

An introduction to market manipulation

Riding to the airport on Tuesday I was reading the Financial Times. It carried two eye-catching pieces.

On page 17, under the headline "***Accelerating probe into Treasuries cheating ratchets up banks pressure***" was a full-page story about how a DoJ investigation into alleged cheating in the US government debt market, and particularly the actions of primary dealers, is "*emerging as a test both for a number of big banks and for the Trump administration*". The article noted that many of the banks targeted in the DoJ probe have "*admitted rigging other markets, meaning they could face especially stiff punishment as repeat offenders if wrongdoing is found*" and that "*a fresh scandal would complicate efforts to ease Wall Street's regulatory burden*" and "*muddy the administration's populist credentials by highlighting its reliance on … former Goldman Sachs executives*."

A Cornell University professor was quoted as saying: "*This is the Big Kahuna. It's the most important of all systemically important prices. If you can't trust the Treasury market? That's momentous*."

On the back page of the same edition, underneath the headline "***Lutnick makes Treasury trading comeback***" and a quarter-page picture of Howard himself, there was a story about how BGC Partners would be showcasing here in Boston its new FENICS UST platform, which he hopes will severely dent BrokerTec's franchise in US Treasuries by delivering much faster and tighter priced execution, and better access to data, than its established rival.

Two pieces that neatly summarised two widely-held beliefs: a lot of nasty stuff happened during the crisis in banks and the regulators are fixing it; and deploying smart technology in markets will make sure that stuff never happens again.

I'm here because both these beliefs are misguided. Let me start with five uncomfortable truths.

First: some news for the Cornell economics department - manipulation of government bond markets has been happening for a very long time.

In 1792, here in the US - just 16 years after Independence - William Duer – the first ever 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 then infant market in US Treasury bonds.

But we don't have to reach back into ancient history. In more recent times, some of you here today may remember the Salomon squeezes on the 4 and 5 year notes in 1991 and 1992.

Or the 10 year futures cheapest-to-deliver squeeze by Fenchurch in 1993.

And manipulation is certainly not restricted to the US or to government bond markets. In the past two centuries, there have been many <u>hundreds</u> of cases brought by enforcement authorities <u>globally</u> for wholesale market manipulation and misconduct in virtually every corner of the fixed income, currency, commodities and of course equity markets.

Second: the continuous efforts by lawmakers and regulators over this period to address manipulation and misconduct, though well-intentioned, have manifestly not been effective.

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.

Please note - I am not suggesting that Howard Lutnick's business plan is to manipulate, or assist manipulators of, the Treasury market.

Fourth: the financial cost of this is staggering.

In the past 5 years, banks globally have paid $375 billion in conduct fines, 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 global economy.

Fifth: and this is really the most serious point of all, manipulation has done systemic damage to trust in financial services and eroded the social licence that banks and others in the financial system need to operate.

The cost of that 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.

So, 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 regulation hasn't, and won't, provide us with the answer.

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 nationally-aligned regulation to control global markets in which liquidity is international.

It's hard for regulators to track the pace of new product and market development with the rapid development of derivatives and very high speed business electronic business.

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 people 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, 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 wants the issue priced tight to the reference rate while the investor would like it cheap.

The syndicate desk would like it fairly priced to help distribution in the primary market while the secondary 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 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 perverted 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 call "*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 this won't work.

<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.

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 50% 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.

Over half our member firms are here in Boston 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 trying 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 I believe have 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 actor – or even group of actors - to address.

And all our Members undertake to adopt our Standards when they join FMSB, and evidence publicly each year that they are actually doing so, and how.

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.

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 vital step along the road to demonstrating trustworthiness – and in due course help to rebuild the trust itself in markets that has been lost this last decade.

What is FMSB actually doing?

Last year we published 5 pieces of work covering a 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;

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:

- 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;
- front office supervision of trading businesses;
- monitoring of e-communications and the use of lexicons;
- suspicious transaction monitoring in FICC markets
- governance of algo trading engines;
- commonly occurring abusing trading practises in FICC markets.

I expect that we will publish about 10-12 Standards this year and next, and 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 know how to fill the void in their own way.

So, while I am very confident of success, the stakes are also very high.

Ladies and Gentlemen, thank you for your attention.