THE
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INVESTMENT MATTERS

The Investment Association's Response to the Fair and Effective Markets Review's Consultation Paper

How fair and effective are the fixed income, foreign exchange and commodities markets?

Executive Summary

The Investment Association represents UK investment managers. We have over 200 members who manage more than £5 trillion for clients around the world. Our aim is to make investment better for clients so that they achieve their financial goals, better for companies so that they get the capital they need to grow, and better for the economy so that everyone prospers.

The Investment Association agrees that there is a need for fair and effective fixed income, currency and commodities markets (FICC). Fair and effective markets would ensure that investment managers are in the best possible position to help the ultimate end users of these markets to:

- build resilience to financial adversity;
- achieve their financial objectives; and
- maintain a decent standard of living as they get older.

Fair and effective markets would also help investment managers to maximise their contribution to economic growth through the efficient allocation of capital.

The recent cases of misconduct in the in the FICC markets have not only highlighted weaknesses in the FICC market structure, they have further damaged the reputation of the financial services industry. We welcome the concerted efforts from the regulators in addressing these cases of misconduct and the various regulatory initiatives (eg. benchmark regulation) that have been put in place to ensure that these weakness are addressed at a global, regional and national level.

Since 2008 FICC markets have experienced far reaching and comprehensive reforms designed to promote greater market stability and increased transparency. Yet despite regulators' shared commitment to key objectives, these reforms have often overlapped and been inconsistent.

For example, in the derivatives markets individual jurisdictions have sought to address the goals set out in the G20 Pittsburgh summit to promote central clearing, margin, capital, conduct and trade reporting in different ways; in the US through Dodd-Frank, in Europe through the European Market Infrastructure Regulation (EMIR) and Markets in Financial Instruments Directive (MiFID II), and through similar measures in Asia. This has resulted in a multitude of new entity and transaction rules being implemented in each jurisdiction with different timings on when these rules will be in full force.

This approach to regulatory reform has not only increased regulatory uncertainty in the markets but has created an environment that could result in;

- fragmented markets as participants make venue choices based on the avoidance of administrative complexity;
- the distortion of competition between market participants due the uneven application of duplicative regimes; and
- regulatory arbitrage as business moves towards more favourable regulatory regimes.

Our members would welcome greater international co-ordination in the development and implementation of regulation.

In setting out its recommendations, we encourage the Review to build upon the existing reforms when addressing some of the deficiencies that are highlighted in our response below. This should take into account the range of regulatory reforms that are currently underway in FICC markets such as EMIR, Dodd-Frank, the Market Abuse Directive, EU and UK benchmark regulation that have not had time to bed down; and others such as MiFID II which are still progressing through the EU legislative process.

Given the international nature of FICC markets, the Review should seek to strike a balance between any further reforms that will be required at national, regional and international level.

Key Recommendations

Market Microstructure

Fixed Income

- The use of electronic platforms should remain optional and should not be mandated by regulation.
- The size of syndicates in new issues have become too large and should be limited.
- Regulators should increase their focus on transparency in other areas of fixed income markets, in particular the disclosure of information by issuers in the new issue process. For new issues:
    - documents be should made available to investors on a timely basis to ensure that they have enough time to read the prospectus and the terms and conditions of the bonds before being required to place an order;
    - unusual or off-market features of the transaction should be specifically highlighted during the roadshow and investors should be allowed to keep the roadshow presentations as part of this process;
    - ancillary documents such as intercreditor agreements or trust deeds should be publicly available to investors on an ongoing basis until the instrument reaches maturity; and
    - information should be made publicly available to bondholders on an equal basis, either via the company's open investor relations website or via other sources such as financial data vendors.

  This information should also be available on an ongoing basis until the fixed income instrument reaches maturity.

  These additional disclosure requirements should be considered as part of the Prospectus Directive Review in 2015.

- There should be more transparency in the allocation of new issues. This information should include, at a minimum, the coverage of the order book, the strike price, distribution broken down by investor type and geographic location, highest and lowest percentage allocations that have been made vs the orders placed.

Foreign Exchange

- An effective and proportionate post-trade transparency framework would be helpful in eliminating last look practices. This would need to be correctly calibrated to ensure that it does not have a negative impact on the effective operation of FX markets.

Regulatory measures

- The current thresholds set under the Prospectus Directive for debt securities to qualify as wholesale debt should be reduced during the 2015 Prospectus Directive Review. This would help in providing more liquidity in the corporate bond market in the long term.

Conflicts of interest and information flows

- There should be further transparency on when a dealer is acting as principal or agent. This could be accomplished by including an additional symbol (P for principal and A for agent) when prices are quoted.

Competition and market discipline
- A means to allow collective engagement by the buy-side with particularly problematic counterparties should be considered. Such collective action could be based on the precedent set by The Investment Association's Special Committee process.

Benchmarks
- Index providers should be required to consider the views of end-users as part of their review into whether foreign exchange fixes used in the calculation of their indices are fit for purpose.
- There should be further clarification and disclosure of benchmark methodologies.
- An industry panel should be established to discuss benchmark use and design. This panel should include asset managers and the users of benchmarks and index providers.
- IOSCO should publish an annual review of how its Principles for Financial Benchmarks are being used. These findings would be an important consideration in the due diligence processes that asset managers routinely undertake.

Standards of market practice
- There should be more communication of standards of market practice across FICC markets. Such standards should be communicated from regulators to firms, and within firms, from management to employees.
- The buy-side would benefit from visibility of sell-side codes of conduct.

Responsibilities, Governance and Incentives
- Market initiatives would be the best source of reform to improve governance frameworks that extend beyond the board to include senior management and that are clearly communicated within the organisation.
- Whilst supportive of individual accountability within banks, it is critical that the structure of the regulatory regime enables effective delegation, as opposed to requiring micromanagement from executives by effectively imposing strict liability on senior persons.
- Firms that participate in FICC markets should be encouraged to create codes of practice that would allow them to assess their standards of behavior against a common framework.

The Investment Association looks forward to continued engagement with the Fair and Effective Markets Review and welcomes further discussion on any of the points that we raise in our response.

The Investment Association Response

What does 'Fair and Effective' mean for FICC markets?

1. **The Review would welcome respondents' views on the definition of 'fair and effective' FICC markets proposed in Section 3. Does it strike the right balance between safeguarding the interests of end-users without unnecessarily impeding the effectiveness of FICC markets? Are the concepts of transparency, openness and equality of opportunity appropriately specified? And how does the definition compare with those used in other markets, jurisdictions, organisations or legislation?**

We agree that the characteristics of 'fair' markets should result from:

- clear and consistently applied standards of market practice;
- sufficient transparency giving participants common access to the information necessary;
- open access to FICC markets for all - either directly or through an open, competitive and well-regulated system of intermediation; and
- market participants acting with integrity.

We also agree that 'effective' markets should:

- operate in ways that allow end-users, borrowers, and end investors to undertake transactions including risk transfer and channelling savings to investments; and
- allow participants to trade at competitive prices.

However, the definition of fair and effective markets should focus on equality of opportunity rather than equality of outcome to ensure that a balance is stuck between safeguarding the interests of end users without impeding the effectiveness of FICC markets.

When seeking to safeguard the interests of end-users in FICC markets, it is important to establish who those end users are. As FICC markets are wholesale markets, the end-users will be eligible counterparties and professional clients (including fund managers) who understand these markets. A distinction should therefore be drawn between these end users and retail investors. That said, retail investors would be significantly impacted if there are inefficiencies in wholesale markets.

It is also important to define the purpose of transparency in these markets. There has been concern that as regulators seek to increase transparency in fixed income markets (for example, under MiFID II) this could further reduce liquidity; impacting effective price discovery and increasing market fragmentation as market participants looking to trade in large volumes seek alternative trading arrangements.

In this context, The Investment Association's members would welcome an effectively calibrated pre- and post-trade transparency regime that reflects the liquidity of different asset classes and takes into account the size, timing and nature of each individual trade. The data standards should be fully harmonised at the European-level to allow aggregation and printing onto a single tape of record, a task which is incumbent upon ESMA to deliver as part of its mandate under MiFID II. This would help ensure best execution for clients and help mitigate any unintended consequences, such as an impact on liquidity and subsequent pricing resulting in a negative effect for the ultimate end user.

Regulators should increase their focus on transparency in other areas of the fixed income markets, such as the disclosure of information by issuers during the new issue process and thereafter. For new issues and an ongoing basis:

- documents should be made available to investors on a timely basis to ensure that they have enough time to read the prospectus and the terms and conditions of the bonds before being required to place an order;

- unusual or off-market features of the transaction should be specifically highlighted during the roadshow and investors should be allowed to keep the roadshow presentations as part of this process;
- ancillary documents such as intercreditor agreements or trust deeds should be publicly available to investors on an ongoing basis until the instrument reaches maturity; and
- information should be made publicly available to bondholders on an equal basis, either via the company's open investor relations website or via other sources such as financial data vendors. (See question 7)

A framework for evaluating fairness and effectiveness

2. Of the six themes identified in Table A on page 5 (market microstructure; competition and market discipline; benchmarks; standards of market practice; responsibilities and incentives; and surveillance and penalties), 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? Do these answers vary across jurisdictions, or specific markets within FICC? Are there any other important areas of vulnerability that are not identified in the table?

The recent series of FICC market abuses occurred as a result of a lack of appropriate regulatory disclosure, surveillance and enforcement. While new rules may be necessary, the focus should be on effectively implementing the EU Market Abuse Regulation and how best to enforce this and other existing rules. This includes enforcement by both regulators and firms.

There also needs to be a cultural shift in the industry whereby individual market participants take personal responsibility for their behaviour. The large fines that are currently imposed on firms not only undermine public confidence in the financial system but ultimately impact shareholder returns. This means that shareholders are bearing the cost for individual misconduct. Shareholders should and do seek to ensure firms use remuneration structures that incentivise good behaviour and do not reward failure. For example, The Investment Association's Principles of Remuneration state that remuneration structures should include provisions relating to malus (reduction or forfeit of an unpaid bonus) and/or clawback (recovery of sums already paid). However, there are limits to shareholders' powers and responsibility for culture and conduct within an organisation. This responsibility ultimately lies with the Board.

Accordingly, The Investment Association's members would support higher sanctions on individuals responsible for misconduct while avoiding inequitable treatment of the broader shareholder base. This approach coupled with the impact on the careers of individuals implicated in cases where sanctions are applied would have a significant effect in deterring any future market misconduct.

<u>Global Deficiencies</u>

The lack of regulatory consistency on a global level is one of the principle concerns for our members. As a result of these inconsistencies, market structures that were previously understandable and explicit are now complicated and opaque. For example some countries have a consolidated exchange feed and must satisfy best bid or offer quotes whereas others do not.

Delays in implementing regulations are having a detrimental impact on FICC markets. For example, delays in the implementation of EMIR have led to a lack of recognition between the EU and the US in swap clearing. This is resulting in a two-tier market between central clearing in the US under Dodd-Frank and in the EU under EMIR.

The Investment Association's members would welcome greater international co-ordination in the development and implementation of regulation.

Barrier and digital options

3. **Do trading practices involving barrier or digital options pose risks to the fairness and effectiveness of one or more FICC markets? How hard is it to distinguish between hedging and 'defending' such options in practice? 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?**

The Investment Association's members would welcome increased disclosure of significant barrier options. Such disclosure would make it clear whether those engaged in this type of trading are hedging or seeking to move markets.

Market microstructure

4. **Does the market microstructure of specific FICC markets — including trading structures, transparency, asset heterogeneity or market access — enhance or diminish fairness and effectiveness? Where there are deficiencies, will recent or in-train regulatory or technological changes improve the situation, or are further steps needed? How do these answers vary across jurisdictions, or specific markets within FICC?**

As noted by the review, FICC markets have been built around a 'market making' system in which market participants trade bilaterally with an intermediary on an over- the- counter basis. This allows market participants to trade large (sometimes heterogeneous) positions without significant price volatility and provides liquidity to the market ensuring effective price discovery.

For several years, investors have been concerned about the deteriorating liquidity in the corporate bond market. This is due to regulatory changes that have limited proprietary trading and increased liquidity requirements for banks, which in turn have reduced the return on capital of market making activity and diminished banks' ability to warehouse risk.

MiFID II will significantly change the market structure as trading moves on to organised trading facilities. This will mean that a substantial amount of fixed income business previously done over- the-counter will now be subject to greater regulation and increased transparency. This has increased concern about the further negative impact that these changes will have on market liquidity.

In addition to regulatory changes, there has been an increase in new issue volumes as issuers seek to take advantage of the lower interest rate environment. Therefore the size of the market has increased whilst trading capacity has decreased.

As a result there has been an increase in the number of electronic trading venues being developed to allow the buy-side to trade directly with each other or with the sell side. However, these venues currently see limited trading activity. This can be expected to increase as market participants adapt to the change in market structures and begin to accept that these platforms will provide an opportunity for uncovering more liquidity.

In fixed income:

5. **Is greater use of electronic trading venues for a wider range of market participants possible or desirable? Are there barriers preventing a shift to a more transparent market structure?**

The Investment Association's members are supportive of greater use of electronic trading venues as appropriate. The automation of smaller sized trades in liquid fixed income instruments make it easier and faster to process trades therefore reducing operational risks. Electronic trading also facilitates an infrastructure that can promote transparency in these markets. However, for trading in large illiquid instruments it is expected that brokers will still be needed for effective execution.

For these venues to be effective, there would need to be significant consolidation amongst the current providers before adoption can have the potential to be more widespread. For example, there are more than 25 different platforms currently operating or in development. Traders' IT infrastructure will have difficulty in coping with such a multitude.

Even in markets where electronic trading works well, it is not clear whether these venues would provide greater liquidity in times of market stress.

Overall, our members would prefer to have these venues available as an option to trade on rather than being mandated by regulation to use them.

MiFID II will significantly change the market structure and will increase both pre- and post-trade transparency. These changes should be allowed to bed down before considering further regulatory reform.

6. **Is standardisation of corporate bond issuance possible or desirable? Should standardisation be contemplated across a broader range of fixed income products? How that could be brought about?**

New issue market practices have led to a FI market where corporate issuers have a large number of debt instruments outstanding and investors' holding and trading activity is broadly dispersed across a universe of bonds. This situation has arisen over time with companies issuing a new bond to limit re-financing risks and to take advantage of favourable market opportunities. Whilst some of our members are supportive of standarisation of corporate bond issuance, others are not.

This is because standardisation may:

- unduly limit issuers ability to appropriately target their funding and manage their balance sheets;
- limit the ability of SMEs to access corporate bond markets because they would be unable to adhere to the requirements for issuing standardised bonds;
- introduce market volatility by having greater concentration in the mandated maturity profiles; and
- limit the ability for institutional investors such as insurers and pension funds to appropriately match their assets and liabilities.

Standardisation alone will not increase liquidity in corporate bond markets.

For this approach to be effective, requirements for standardisation should be:

- implemented at a global level taking into account the impact on the primary bond markets;
- limited to large and frequent issuers; and
- undertaken with extensive consultation with issuers to ensure that their funding needs are not curtailed.

7. **Should the new issue process for bonds be made more transparent through the use of auction mechanisms, publication of allocations or some other route?**

Our members have raised significant concerns about the new issue process. These relate to:

- syndicate sizes;
- disclosure of prospectuses and other relevant documentation;
- the bookbuilding process;
- publication of price guidance;
- new issue allocation; and
- order book distribution and disclosure.

Syndicate size

A syndicate of banks provides the required access and distribution to an investor base that will ultimately make long term investments in the corporate bond market. For the efficient delivery of this aim, the syndicate needs to maintain a balance between achieving depth of distribution to a wide range of investors whilst avoiding seeking particular investors opinion on pricing multiple times.

There is a belief that the size syndicates on new issues are generally too big, and the desired outcomes could be delivered with fewer banks involved. While in continental Europe large syndicates are sometimes driven by the need to cover a number of key countries or regions with different distribution needs, it is not clear why this should generally be the case in the UK, given that it is a single country with a relatively homogeneous institutional investor base. Equally, there is no merit in a single bookrunner deal as the secondary liquidity often suffers.

The Investment Association members would welcome a limit on syndicate sizes.

Disclosure of prospectuses and other relevant documentation

Transactions for frequent issuers (with an established credit curve and documentation) are issued in a very short timeline and are less likely to involve roadshows or preliminary 'red herring' prospectuses when compared to transactions for inaugural and infrequent issuers.

Currently, red herring prospectuses for investment grade bonds are only made available up to an hour before the order book is opened and the final prospectus is only made available after the order book is closed and the deal is priced.

As a result, investors have to rely on the information that is provided to them during the investor call (or roadshow, where one is conducted) to assist them in making their investment decision. This timing and lack of information is a challenge for investors as they need to review the relevant transaction documentation, obtain credit approvals or consult colleagues internally to consolidate interest from several sub-funds (potentially across different time zones).

In addition, investors are not able to gain access to the Trust Deed unless they can prove to the Trustee that they are actual owners of the bond in question. Yet both the prospectus and the trust deed contain the key terms and conditions for the bond that assist investors in formulating their investment decisions.

It is our members view that for new issues:

- documents should be made available to investors on a timely basis to ensure that they have enough time to read the prospectus and the terms and conditions of the bonds before being required to place an order;
- unusual or off-market features of the transaction should be specifically highlighted during the roadshow and investors should be allowed to keep the roadshow presentations as part of this process;
- ancillary documents such as intercreditor agreements or trust deeds should be publicly available to investors on an ongoing basis until the instrument reaches maturity; and
- information should be made publicly available to market participants on an equal basis, either via the company's open investor relations website or via other sources such as financial data vendors.

This information should also be available on an ongoing basis until the fixed income instrument reaches maturity.

These additional disclosure requirements should be considered as part of the Prospectus Directive Review.

Bookbuilding process

For new fixed income transactions, the order book is typically kept open for a minimum of 60 minutes. However, in some cases the order book can be opened during the roadshow with the syndicate banks taking orders throughout the process. It is not always clear when or how the books are actually open vs investors being asked to submit indications of interest.

As part of the bookbuilding process, the syndicate will issue several iterations on the size of the book in a number of minutes. This typically results in oversubscription that ultimately impacts allocation. Conversely, some banks refuse to provide any information on how the book build is progressing altogether.

The Investment Association's members would welcome a general rule to limit the communications on the development of the book. Guidance should be issued requiring syndicates to ensure that communication on the order book should be kept to a minimum. For example, this can be achieved by issuing the following communications:

- Books open
- Bookbuilding (announcement that book is e.g. 0-80% covered)
- Book subscribed (when the book is between e.g. 80% - 130%)
- Book oversubscribed and closing (when book reaches e.g. 130%)
- A final price

Such an approach would give the syndicate sufficient flexibility in communicating with the market whilst limiting the information investors receive therefore limiting order inflation where that is driven by uncertainty about allocation. The final book size should only be disclosed after the books have closed.

The Investment Association's members are supportive of any progress that is made toward greater automation of the order process. This should include:

- Automated orders for new issues from the buy-side to one lead manager or directly to the syndicate book; and
- Automated allocations back to buy-side firms once the order book has been closed, so as to minimise the risks associated with the manual order procedures.

This would promote efficiency by limiting human error in deal execution and will promote fuller disclosure.

New issue allocation

As described above, order inflation is of particular concern in the new issues market. Order inflation happens when investors place orders that are larger than their true internal demand. This is because the investor:

- anticipates that the order will be reduced on allocation because of oversubscription;
- overestimates demand because they were unable to confirm internally prior to placing its order due to a limited timeframe; or
- anticipates particularly strong demand by other investors and so expects to liquidate part of its allocation in initial secondary trading to crystallise the initial issuance premium ('flipping').

Although some investors do not order inflate, those that do disadvantage genuine investors that are seeking their precise allocation and will have to go to the open market and purchase additional bonds at a premium.

Bookrunners have a key role in ensuring fairness in the allocation process. In particular, they should be required to ask investors to explain why:

- orders that appear to be out of proportion compared to previous transactions or assets under management; or
- orders have been placed laced at a relatively late stage in the process. However this is further complicated by the limited time that investors may have to confer internally with colleagues managing other funds.

Order book distribution and post –trade transparency

As part of the need to ensure more post-trade transparency, The Investment Association members would welcome greater transparency on, as a minimum, the coverage of the order book, the strike price, distribution broken down by investor type and geographic location, highest and lowest percentage allocations made vs the orders placed.

This information should be provided for all new issue fixed income transactions.

Alternatives to the new issues process

As part of the consideration on how to deal with the issues identified above, some of The Investment Association's members would welcome consideration of an auction process similar to that used in the UK Gilt Market. This would help to eradicate order inflation.

It is argued that this auction process may also only be feasible for some investment grade bonds which tend to be more standardised in nature.

However, some of The Investment Association's members are not in favour of an auction process. This is due to concerns that an auction process may:
- lead to allocation based on price alone. This would not allow the issuer to consider issues such as diversification of their investor base or whether the potential investor is likely to hold the bonds on a long term basis.
- reduce focus on deal structures and documentation. This would be inappropriate for high yield and emerging market transactions where the structure and covenants of these instruments are key for investors and the orderly operation of these markets.
- disincentivise investors to allocate resources to the pre-marketing phase of a transaction. At the moment a lot of work is done by investors during the pre-marketing phase including checking documents, speaking to management and helping to ensure that deals comply with a minimum standard. If this were lost, it is likely that there would be a deterioration in the quality of deals coming to market.
- lead to a two-tier market with larger investors participating in private placements which have been shaped by those investors, and the public market suffering from poor structures and documentation as a result of the migration of large investors to private placements.

In foreign exchange:

8. Are there risks associated with internalisation and last look practices? Are there barriers preventing increased pre and post-trade transparency in foreign exchange markets?

Internalisation

Our members agree with the benefits of internalisation including the ability to:
- trade at narrower bid-offer spreads;
- demonstrate best execution due to electronic confirmations; and
- source multiple prices from different single and multiple-dealer platforms.

We note the concerns about the lack of transparency and concentration of information in the hands of several large banks as a result of internalisation in FX markets. However, as in the equity market, there is no clear proof of the correlation between the level of internalisation and reduction in the quality of the market.

It is our members' view that even though the market has become significantly more concentrated, it remains highly competitive. The quality of execution has not diminished orders of a material size are still unlikely to move the market substantially. Despite the increased market concentration, buy-side firms retain the ability to stop dealing with counterparties who they do not feel offer an acceptable quality of execution. Enhanced counterparty risk management techniques such as CLS enable buy-side participants to be more comfortable with more concentration among the best-in-class counterparties.

Last Look

That said, our members have raised concerns about last look practices. This is due to concern about the speed that trades in FX markets are executed and the information asymmetry that this practice introduces. Last look can allow a bank to hold an asset manager's trade for a duration of time giving the bank an opportunity to front-run the trade.

An effective and proportionate framework of post-trade transparency would be useful in informing asset managers the accessible liquidity and would highlight situations where front running has occurred. Such a framework would need to be correctly calibrated to ensure that it does not have a negative impact on the effective operation of FX markets.

9. Are there barriers impeding the development of more comprehensive netting and execution facilities for transacting foreign exchange fix orders?

The Investment Association's members would welcome the establishment of independent netting and execution facilities that would help mitigate conflicts of interest and introduce more transparency. Independent netting would reduce market risk as this can be done at the same time and at the same rate. This facility can then execute residual orders using a pricing mechanism, which determines the clearing price against liquidity providing orders within the order book.

Any solution that seeks to create such an independent facility will need the support of index providers or the benchmark agencies.

In commodities:

10. Are there any material barriers preventing greater transparency in OTC commodity derivatives markets? If so, what could be done to remove them?

Pricing in commodities derivative markets is relatively transparent as they are exchange traded and subject to transaction reporting requirements under EMIR. However, the effectiveness of this transparency is dependent upon the availability of reliable data on physical markets which varies significantly.

Due to the global nature of the physical markets, any initiatives to increase transparency will need global co-ordination and should not focus only on trading in the EU or the UK.

Regulatory measures:

11. 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?

EU

Our members are increasingly concerned about the lack of liquidity in the corporate bond market. One way to address this concern is to reduce the minimum thresholds required under the Prospectus Directive (PD) for debt securities to qualify as wholesale debt and therefore for exemptions under the aforementioned directive and the Transparency Directive.

During the last PD Review in 2012, the minimum threshold was increased from €50,000 to €100,000. This was done to address the European Commission's concern that the €50,000 threshold was too low to prevent retail investors from investing in products that the Commission considered should only be placed with professional investors. However, this has resulted in some wealth managers and asset managers not being able to participate in new fixed income transactions as the current €100,000 denomination is too high to meet their clients' needs for smaller ticket sizes. If the denomination was lower, this would open up the pool of liquidity that is available amongst these managers' clients.

There have been concerns about how to treat clients fairly under the current thresholds. For example, if two small funds apply for €100,000 of new issue and the firm is only allocated €100,000 rather than the €200,000 order that was placed, they would have to make a decision on which fund to allocate the €100,000 to. This compares to if the minimum denomination was €50,000 in which case they would be able to split the order evenly.

The Investment Association would welcome a decrease in the current thresholds during the 2015 Prospectus Directive Review.

MiFID II will implement a pre and post-trade transparency regime. There is concern that the pre-trade measures as currently drafted will disincentivise brokers from quoting prices which could damage trading and liquidity even further. Equally, if the post-trade transparency does not allow for a suitable time delay before disclosure, market practitioners will opt for alternative venues such as 'dark pools'.

It is imperative that an effectively calibrated pre-and post-trade transparency regime that reflects the liquidity of different asset classes and takes into account the size, timing and nature of each individual trade is established.

Global Level

Since 2008 FICC markets have experienced far reaching and comprehensive reforms designed to promote greater market stability and increased transparency. Yet despite regulators' shared commitment to key objectives, these reforms have often overlapped and been inconsistent.

For example, in the derivatives markets individual jurisdictions have sought to address the goals set out in the G20 Pittsburgh summit to promote central clearing, margin, capital, conduct and trade reporting in different ways; in the US through Dodd-Frank, in Europe though the European Market Infrastructure Regulation (EMIR) and Markets in Financial Instruments Directive (MiFID II), and through similar measures in Asia. This has resulted in a multitude of new entity and transaction rules being implemented in each jurisdiction with different timings on when these rules will be in full force.

This approach to regulatory reform has not only increased regulatory uncertainty in the markets but has created an environment that could result in:

- fragmented markets as participants make venue choices based on the avoidance of administrative complexity;
- the distortion of competition between market participants due the uneven application of duplicative regimes; and
- regulatory arbitrage as business moves towards more favourable regulatory regimes.

Our members would welcome greater international co-ordination in the development and implementation of regulation.

As noted in Question 10 above, The Investment Association would welcome a global approach to increased transparency in the physical commodity markets.

Conflicts of interest and information flows

12. Where do potential conflicts of interest arise in the various FICC markets, and how do they affect the use and potential abuse of confidential information, both within and between firms?

Our members agree with the conflicts of interest identified by the FEMR including:

- the informational advantages that dealers have when there is a potential for front running and principal –agency conflicts; and
- the lack of clarity about whether a dealer is acting as principal or as agent.

There are concerns about the conflicts that may arise during the allocation of new bond issues in fixed income markets where the bookrunners are advising issuers or deciding who to allocate to, based on subjective factors. Whether or not it does result in the bookrunners treating some of their clients more favourably than others during the allocation process; the fear that there this is happening could lead to market inefficiencies.

13. How can the vulnerabilities posed by such conflicts be reduced? Are existing internal structures and control procedures sufficient? Where they are not, are further internal management controls required (such as better trading floor design and/or closer monitoring of electronic communications within and between firms) or is more radical action required to remove conflicts altogether?

The Investment Association would welcome further transparency on when a dealer is acting as principal or agent. This could be accomplished by including an additional symbol (P for principal, A for agent) when prices are quoted.

For fixed income allocations, we acknowledge that bookrunners have done a lot of work to help eliminate these conflicts. However, more transparency (as outlined in Question 7) would help address any perceived conflicts of interest.

From a regulatory perspective, MiFID II updates the general rules that firms are required to follow in respect of systems and controls.

The EU Market Abuse Regulation (MAR) will extend the scope of market abuse framework to apply not only to financial instruments admitted to trading on an EU regulated market but will also cover:

- any financial instrument admitted to trading on a European multilateral trading facility (MTF) or organised trading facility (OTF); and
- any related financial instrument traded OTC which can have an effect on instruments that are trading on any trading venue that is within the scope of MAR.

Commodity derivatives and benchmarks will also be covered more comprehensively than under the current market abuse regime.

Focus should be on allowing these rules to be implemented and any further work in this area should be based on the evidence gathered as part of the formal review process.

Competition and market discipline

14. Is there a relationship between the level of competition in FICC markets globally and the fairness and effectiveness of those markets? What risks are posed by the increase in concentration seen in some FICC markets? In answering this, please have regard to the geographical scope of any relevant markets.

Although some investment banks have exited some segments of the FICC markets and therefore increased concentration to a smaller number of banks, our members have not experienced a decrease in the fairness or effectiveness of these markets.

Nonetheless, there is concern that the introduction of regulated central clearing for derivatives has inevitably led to concentration of risk in the major clearing houses. Should one of these go through a period of stress, the ramifications on the wider financial system could be severe. There should be clear plans to recover or resolve a CCP, both with regard to the triggers for such action and how it should proceed, given the irreparable damage to a CCP's credibility as a result of exhausting the high level of resources it will have.

Even so, competition should not be a goal in itself but a means to an end, the principle aim being to reduce the costs of trading and improve service offerings.

MiFID II will introduce significant changes to FICC market structures. It is important to allow these to be implemented before determination can be made on whether more changes are required to increase competition.

Promoting effective competition through market forces

15. To the extent that competition is currently ineffective in any of the FICC markets, are there market-led initiatives, technological or structural changes that may remedy this situation?

(See question 14)

16. Are there any lessons that can be drawn from experiences in other financial markets (or indeed other markets) about the ways that alternative or evolving market structures could impact on competition in FICC markets?

It is important to draw a distinction between equity markets and other FICC markets. Recent regulatory changes, in particular MiFID II, have sought to apply equity market rules to other asset classes, in particular fixed income in a bid to establish the same level of pre and post-trade transparency currently seen in the former. This continues to be problematic and comes at the price of reduced liquidity. Indeed, increased transparency can be positive for investors. However, too much transparency in less liquid markets can have a negative impact on liquidity and therefore impact price discovery as noted by the FEMR.

Regulators should be aware that regulatory change often results in unintended consequences. It is imperative that the upcoming changes are allowed to bed down before added reforms are proposed by the Review.

17. How effective is market discipline in enforcing sound market practices in each of the key FICC markets? What could be done to strengthen it?

Large investors are able to manage effectively their relationships with their sell-side counterparts. For example:

- they carry out quarterly broker scoring and annual reviews with their key counterparties which allows both sides to give their views on each other's effectiveness and market practices.
- for key counterparties, they have relationship managers to whom they are able to direct any complaints.

In addition, where there is a perception or experience of misconduct, large investors are also able to withdraw their trading with the particular sell-side firms. The requirement to submit Suspicious Transaction Reports also provides a level of self-regulation within fixed income markets.

However, our members have raised the concern that, with increased market concentration on the sell-side it is becoming more difficult to stop trading with any one counterparty. This is not only because this may lead to increased concentration with the remaining counterparties, but because the investor could end up locked out of particular transactions e.g. a new issue in the fixed income market. There is concern that for smaller asset managers withdrawing business from a sell-side firm would not have the desired impact.

Some members have highlighted that where they have raised concerns with the regulator about a particular counterparty's behaviour, this has resulted in the regulator examining the members' conduct as well, which in turn has led to a reluctance amongst members to report to the regulator any perceived market misconduct. There needs to be a discussion about the culture of whistle-blowing and how this can be promoted within FICC markets.

It has been proposed that one way of dealing with market misconduct could be investors with shared experiences coming together to engage collectively with a particularly problematic sell-side firm. Such collective action could be based on the precedent set by The Investment Association's Special Committee process.

The Investment Association Special Committees can be formed at the request of investors where they are concerned about the underlying value at risk due to an issuer's actions or, where there are critical issues of best market practice in question. This allows the bondholders to come together to exert pressure on an issuer or its advisors to remedy a particular situation and to prevent negative market precedents being set. (See Appendix A for Terms of Reference)

By using such a collective process for interacting with sell-side firms on particular concerns raised by The Investment Association members or other participating investors, backlash from the sell-side firms against individual investment managers could be prevented. Equally, the sell-side could look to establish a similar process to deal with what they felt were particularly problematic buy-side firms.

That said, it is important that the Review does not place the complete onus on the buy-side to police sell-side misconduct. It is also important that any such process includes as wide a range of investors as possible, including both UK and European investment firms.

Our members have also raised concerns about the use of consent fees to incentivise bondholders to vote in favour of proposed amendments to the terms and conditions of an issuer's debt securities. It is common practice for an issuer to propose that the fee will only be payable to those noteholders that vote in favour of the issuer's proposal.

Although the payment of consent fees in exchange for votes in favour of amendments to the terms of debt securities is not unlawful, this approach breaks one of two principles of fairness.

- If the consent fee is characterised as a 'work fee', bondholders voting for or against will have expended the same resources in making their decision. This includes the time and resources expended in understanding the proposal and the back office time required to process a corporate action. It is expected that such firms will vote, but they may not vote in favour. Therefore, it is unfair to discriminate against bondholders who vote against the proposal.
- Alternatively, if the consent fee is characterised as a 'waiver fee' to compensate for a perceived or acknowledged dilution of the bondholder's rights; the consent fee should be paid to all noteholders as they would be all equally affected if the proposals were to be implemented.

There are concerns that a 'waiver fee' may result in bondholders agreeing to modifications that they do not support on principle. This is because if they voted against the proposals, the holders would have to forgo the consent fee to the detriment of their clients' interests. As a result, there is a risk that bad market practice can develop into standard market practice at the expense of bondholder rights.

It is acceptable that fees should only be payable in the event that the resolution is passed and only to those bondholders that vote. However, it is ours and our members' position that consent fees should be paid to all voting noteholders irrespective of whether they vote for or against the proposed modifications.

Governance

Another way to enhance market discipline would be to focus on the governance arrangements operated by FICC market participants. An example of where changes in governance are being instigated in order to enhance overall quality and merits further study in FICC market context, would be the work initiated by under the 'Better Workplace Pensions' agenda.

It is not clear whether any abuses arise through firms not having a mechanism to pre-clear behaviours or new strategies with their regulators. If it were possible to seek clearance from a regulator for a new strategy – or new exploitation of information - as can occur with tax schemes, some firms might utilise this avenue. At the very least those which did not and were later found to have displayed poor market conduct could be fined more heavily.

Promoting effective competition through regulatory and legislative initiatives

18. In what ways might competition in any of the key FICC markets usefully be addressed by competition authorities (e.g. by assessing the state of competition in relevant markets)?

The FCA's thematic reviews are effective in identifying areas of possible concern. At the time of writing this response, the FCA was yet to publish its response to the call for input to the Wholesale Sector Competition Review. This Review sought to explore features of the market or market behaviour that could inhibit or distort competition in the market, including potential barriers to entry or expansion, information asymmetries, conflicts of interest and cross-selling or bundling of services.

We recommend that the Review takes into account the outcomes of the FCA's wholesale competition review as part of its wider considerations.

19. Are there any additional regulatory reforms that could be helpful in promoting competition and market discipline in FICC markets?

Further regulatory reforms could result in an increased barriers to entry rather than create further competition. Any regulatory reforms that are proposed through this Review would need to be supported by a robust impact analysis.

See question 17 above on pre-clearance.

20. 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?

See question 18 above.

The use of existing supervisory powers has focused market participants' attention on areas where standards are below expectations. The Investment Association is of the view that these existing supervisory powers provide the most appropriate way of demonstrating where any improvements to the competition framework need to be made, in the event that issues arise in relation to FICC markets.

Benchmarks

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

From an international perspective, our members are concerned that the recent FSB report on FX Benchmarks recommends that:

- Index providers should review whether foreign exchange fixes used in their calculation of indices are fit for purpose (Recommendation 14). However, the recommendation does not require this due diligence to be transparent to the market or for index providers to include the view of end - users as part of this process.
- Asset managers, including those passively tracking an index, should conduct appropriate due diligence around their foreign exchange execution and be able to demonstrate that to their own clients if requested (Recommendation 15). However, the recommendation does not offer any guidance on how a benchmark can be replaced if it is deemed to be sub-optimal.

We believe that these two areas merit further consideration by regulators.

We would also welcome further clarification and disclosure of benchmark methodologies would be useful for UCITS fund managers as they often find it difficult to obtain the information from the benchmark providers as required by the ESMA guidelines.

Industry-level measures

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

Asset managers are the users of rate benchmarks and market indices when managing portfolios on behalf of their clients. They do not produce or contribute to the data on which the calculation of benchmarks is based. Therefore, asset managers have no direct access to the benchmark setting process and are not able to control their outcome or manipulate it, nor do they use them to price financial instruments.

It is important to note that for segregated mandate accounts, it is not the funds or the fund managers who choose what benchmarks to follow. This is based on the preference of the asset owners (ie. insurance companies and pension funds). Asset owners find value in using benchmarks to express their general wishes to their asset managers to ensure that they have some guidance, and as an evaluation tool for an active manager's performance (ie. to measure fund performance against a set index or a combination of indices. Indices are either used as a target for index linked funds, such a passive investment funds and exchange traded fund (ETFs). This in essence creates a contractual obligation on the part of the manager to price off a specific benchmark.

Asset managers are already subject to extensive requirements and conditions under which UCITS may use financial indices as benchmarks. The ESMA guidelines on ETFs and other UCITS issues[1] foresee that only transparent indices are permitted to be used as a benchmark. These transparency requirements are very extensive covering calculation, re-balancing methodologies, as well as their constituencies and their respective weightings. In addition, indices used as performance evaluation tools need to be disclosed in advance in the UCITS KIID.

Asset managers and FX benchmarks

Since asset managers started managing internationally diversified portfolios, currency conversion has been an issue for most asset managers. Overall, there is very little interest in currency as an investment

[1] (ESMA/2012/832/EN) – Available here: http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf

tool per se, except in strategies such as Global Macro and Pure FX. Therefore, an asset manager's focus on currency is from a practical perspective, namely, the settling of trades arising from the purchase and sale of non-base currency denominated assets and hedging those risks. This tends to be done by middle or back offices within an asset management group, or they may be functions conduct by the client's custodian for segregated mandates.

For asset managers the highest priorities are to have a robust FX process that does not create errors and to effectively hedge assets. Asset hedging is when an asset manager reduces the impact of long-term foreign exchange movements on their foreign denominated assets. This is done by establishing long positions in the base currency against the foreign currency to reduce exposure to foreign currency. These positions are then rolled over each month (sold and re-established for a date in the future) and vary with the value of the underlying assets. The benchmarks used in this process will also typically be stipulated in the mandates provided to the fund managers by the asset owners.

It is therefore inevitable that asset managers will continue to rely on benchmark pricing in the FICC space – at least in the short term. This underscores the importance of thoughtful regulatory reform of critical benchmarks within a broader regulatory environment that does not present a barrier to competitive substitute benchmarks from coming into the market.

Overall, trying to regulate benchmarks through their use by asset managers is not the most effective way to deal with the inefficiencies and potential for manipulation in benchmark setting process. Actively managed funds would seek to trade throughout the day (rather than 'at the fix') with a view of achieving the best outcome. However, this would be particularly difficult for passively managed funds that seek to track the benchmark as closely as possible.

Nonetheless, our members acknowledge that it is critical for buy-side participants to invest in their FX trading capabilities to enable them to effectively manage the aspects of operating in a volatile and global market of wide-ranging and diverse participants.

23. What additional changes could be made to the design, construction and governance of benchmarks?

See question 21 above.

24. Should there be an industry panel to discuss benchmark use and design with the aim of assisting industry transition?

Our members would welcome an industry panel to discuss benchmark use and design. This panel should include asset managers and the users of benchmarks and the index providers.

Regulatory action

25. What further measures are necessary to ensure full compliance with the IOSCO Principles for financial benchmarks by all benchmark providers?

The Investment Association members believe that the most important way to ensure that the IOSCO principles for financial benchmarks are complied with would be to require IOSCO to undertake a comprehensive yearly review of the implementation of the Principles and report their findings to the market. Any findings would be an important consideration in the due diligence processes that asset managers routinely undertake.

26. How can the regulatory framework provide protection to market participants for benchmarks administered in other jurisdictions in a proportionate way?

For the regulatory framework to be proportionate it would need to:

- take account the different types of benchmarks so as not to unjustifiably hamper investment opportunities by restricting innovation, flexibility and creating artificial barriers to entry for new index providers;
- focus on benchmarks that are susceptible to manipulation and conflicts of interest;
- establish transparency in the benchmark setting process; and perhaps most importantly,
- ensure a level playing field for all indices used within the EU, in order to allow investors to have access to a wide range of reputable, robust and cost effective market indices and benchmarks.

The Investment Association members agree with the Review that compliance with the IOSCO Principles for Benchmarks should be the starting point for ensuring that UK consumers are protected when using benchmarks in other jurisdictions. As they are agreed globally, the IOSCO Principles ought to be the basis by which the EU deems its proposed legislation equivalent to other jurisdictions. This is because it is not necessarily the case that other jurisdictions will introduce requirements that are exactly the same as those proposed by the EU Benchmarks Regulation.

As it currently stands, a substantial number of the index funds and ETFs in which UK and other EU consumers invest are currently based on benchmarks from 3rd country providers (i.e. MSCI, S&P, Russell).

The Investment Association members are concerned that the requirements imposed on 3rd Country index providers under the regulation are likely to be problematic, disproportionately burdensome and/or undesirable for such providers. This could lead to the exit of many providers (especially smaller ones). This would significantly disrupt the benchmarks landscape in the EU, by reducing the scope of index provider options and lead to a concentration of market power in a few index providers with the risk of oligopolistic pricing. This will ultimately be to the detriment of EU investors.

Standards of market practice

27. Are existing sources of information regarding standards of market practice across FICC markets globally: (a) already sufficiently clear (or will be once current regulatory reform has concluded); (b) sufficient, but in need of clearer communication or education efforts; or (c) not sufficiently clear, requiring more specific guidance or rules to provide more detail or close genuine gaps?

The Investment Association members would be supportive of further communication of standards of market practice across FICC markets. Such standards should be communicated from regulators to firms, and within firms, from management to employees.

The buy-side would benefit from visibility of sell-side codes of conduct. Where guidance is issued by trade bodies, for example in relation to the use of inside information, this should be widely accessible and promoted to the market.

28. Box 7 on pages 36–37 discusses a number of uncertainties over FICC market practices reported by market participants, including: the need for greater clarity over when a firm is acting in a principal or an agency capacity; reported difficulties distinguishing between legitimate trading activity and inappropriate front-running or market manipulation; and standards for internal and external communication of market activity. To the extent that there are uncertainties among participants in the different FICC markets over how they should apply existing market standards in less clear-cut situations, what are they?

We agree with all the uncertainties listed.

29. How could any perceived need to reduce uncertainties best be addressed: (a) better education about existing standards; (b) new or more detailed market codes on practices

or appropriate controls; or (c) new or more detailed regulatory requirements? Will these uncertainties be dealt with by current reforms?

The perceived need to reduce uncertainties will be best achieved by better education on existing standards. The industry should continue to develop best practice standards that would help reduce uncertainty about the standards to which market participants should adhere in various situations.

For example, FICC markets could benefit from a rulebook that is similar to the London Stock Exchange Rule book that set out market making rules, settlement, clearing and benefit rules etc.

30. How can the industry, firms and regulators improve the understanding of existing codes and regulations by FICC market participants and their managers?

Transparency and regular reviews of existing codes would be useful in improving the understanding of existing codes and regulations. As noted above, a culture that admits to where such codes are unclear or are 'being gamed' so that they can be improved would be an advantage.

There is often a fear of raising standards due to concern that any attempts to do so will be seen as an admission that previous conduct has been delinquent. The financial industry needs to be able to approach regulators to agree step changes in behaviour in the knowledge that, whilst not absolving egregious offenders, this will not trigger an enquiry.

31. Should there be professional qualifications for individuals operating in FICC markets? Are there lessons to learn from other jurisdictions — for example, the Financial Industry Regulatory Authority's General Securities Representative (or 'Series 7') exam? Can the industry help to establish better standards of market practice?

The Investment Association's members are supportive of licensing and qualification requirements for individuals operating in FICC markets that is relevant to the jurisdiction in which they operate. This should take into account the relevant qualifications already in place (eg. the Investment Management Certificate or the Chartered Financial Analyst Program).

One proposal that has been put forward is that existing professional qualifications should include annual continuing professional development (CPD) updates. Other certifications, including those under the new Strengthening Personal Accountability, the current Approved Persons Regime and the continued fit and proper assessments could also be contingent upon the completion of the CPD updates.

At the very least, firms should be responsible for ensuring that they provide ongoing education and that all their employees remain fit and proper throughout their time at the firm.

32. What role can market codes of practice play in establishing, or reinforcing existing, standards of acceptable market conduct across international FICC markets?

To ensure that codes play a significant role they should be developed by a broad range of financial industry participants at an international level to allow for the individual FICC markets to reflect their differences. (For example, by organisations similar to the Hedge Fund Standard Board).

In the FX market, the ACI's (Association Cambiste Internationale) Model Code already seeks to define the principles and ethics that market professionals in the FX markets should adhere to in order to uphold market standards. It also makes a clear statement about the responsibilities and supervisors to ensure that codes of conduct are strictly maintained. However this a voluntary code. Consideration should be given to how it could be made more effective by formalising (eg. through endorsement by regulators) it for both the buy and sell-side.

33. How would any code tackle the design issues discussed in Section 5.4.3, ie: how to ensure it can be made sustainable given industry innovation over time? How to differentiate it from existing codes? How to give it teeth (in particular through endorsement by regulatory authorities or an international standard setting body)? How to communicate it to trading teams? Whether, and how, to customise it for individual asset classes? Should the scope of regulation be extended?

It is important that codes strike a balance between being too high level, too detailed and negative (i.e. stating what is unacceptable, without saying what is acceptable).

The industry would support the publication of a clear list of acceptable practices (including safe harbours) and a list of unacceptable practices, and a requirement for front office staff to know and understand these and how to escalate concerns if the facts in question seem to fall under neither category. These codes should be in plain English with limited legal jargon.

Such market codes can be used for training, promotion and reputational accountability.

34. In the context of implementing MiFID 2, which of the FCA Principles for Businesses should apply in relation to MiFID business with Eligible Counterparties?

MiFID introduces the obligations to act 'honestly, fairly and professionally' and communicate in a way that is 'clear, fair and not misleading.' The Investment Association considers that these obligations are equivalent to FCA Principles 1 (Integrity), 2 (Skill, care and diligence) and 7 (Communications with clients). The Investment Association welcomes the implementation of these principles as being conducive to encouraging behaviours of a good standard. However, such principles should be proportionately applied across to eligible counterparties taking into account the sophisticated nature of their business.

35. Are there any financial instruments that should be brought more fully into the scope of regulation in order to improve the fairness and effectiveness of specific FICC markets? For any instruments proposed: (a) what protections does the current framework provide; (b) what gaps remain of relevance to fairness and effectiveness; and (c) what is the cost/benefit case, bearing in mind the Review's Terms of Reference as set out in Section 1?

We do not believe that standards of market practice should be limited to particular financial instruments.

Responsibilities, governance and incentives

36. How much of a role did inadequate governance, accountability and incentive arrangements play in the recent FICC market abuses, and to what extent do these remain potential vulnerabilities in FICC markets globally? In addition to on-going regulatory changes, what further steps can firms take to embed good conduct standards in their internal processes and governance frameworks? And how can the authorities, either internationally or domestically, help to reinforce that process, whether through articulating or incentivising good practice, or through further regulatory steps?

Poor oversight played a major role in recent FICC market abuses. Before the crisis many firms had insufficient risk systems in place, and showed a reluctance to discipline individuals that were bringing in high profits. In part these abuses also related to an incentive structure that leaned more towards short-term profits, offering insufficient long-term alignment with the overall health and performance of the business and the returns delivered to shareholders.

Since the Financial Crisis there have been a number of changes to the structure and assessment of remuneration, through the introduction of the FCA Remuneration Code. Requirements in the Code include the governance of remuneration decisions across the organisation, increased deferral of variable remuneration, the introduction of malus and clawback provisions, a broader range of performance factors and capping variable remuneration for Code staff. The impact of these changes are still being assessed but we believe they are starting to have an impact.

We do not believe that as investors, we have a sense of the governance structure and its implementation in FICC markets. An improved governance framework must extend beyond the Board to include senior management as well, and so internal Codes of Practice must be strengthened and adhered to. The Investment Association believes that market initiatives can be the most effective source of reform.

As with other issues relating to FICC markets, the response must be international in order to be effective, and efforts to improve best practice across Europe and globally are welcomed by The Investment Association.

Firm-wide initiatives to improve incentives and governance

37. Do respondents' agree that the thematic areas highlighted in Section 5.5 are key priorities for FICC firms (fine-tuning performance measures; adjustments to remuneration; attitudes towards hiring, promotion and advancement; closer board involvement in governance of FICC activities; and clearer front line responsibilities)? What specific solutions to these challenges have worked well, or could work well? And how best can the authorities help to support these initiatives?

The Investment Association agrees that these are key priorities. We note that firms have already taken steps towards the fine-tuning of performance measures and having the ability to make adjustments to remuneration. There has also been fine-tuning of performance measures, which are both increasingly varied (more accurately reflecting business and company performance rather than just individual performance) and more sophisticated, avoiding simply encouraging maximum profits without examining the potential long-term risks. Most banks, for example, now assess performance against a balanced scorecard, which is based on a number of factors aside from profits. We believe that ultimately these steps will encourage closer long-term alignment between the pay given to individuals and the overall performance of the firm. The Investment Association welcomes the continued drive by both firms and shareholders to push for best practice.

We are supportive of individual accountability within banks. However, it is critical that the structure of the regulatory regime enables effective delegation, as opposed to requiring micromanagement from executives by effectively imposing strict liability on senior persons. We believe that the regulatory regime should encourage professional responsibility at all levels. In this regard, the first line of defense approach outlined in the consultation document is an important concept which should be promoted.

However, The Investment Association believes that, for these methods to be effective, the correct culture must be put in place. Good standards of practice must not only be practiced by the Board and executive team, but must be clearly communicated down through the organisation. It is up to senior management and the Board to ensure that the correct culture is encouraged and developed throughout the organisation. The imposition of a positive culture should extend to hiring, promotion and advancement of individuals, ensuring that the right individuals, with the right behaviours, are in place throughout the firm.

The Investment Association would therefore encourage firms to share examples of best practice, and would welcome the creation and extension of industry codes of practice, which would allow firms to assess their standards of behaviour against a common framework.

The Investment Association would consider the imposition of the correct corporate culture to be the most significant step firms can take towards addressing deficiencies in FICC markets.

Market wide initiatives to align market conduct, incentives and governance

38. To what extent could the Banking Standards Review Council help FICC market participants to raise standards collectively — in particular, are there other steps that could be taken to help complement or extend this initiative in FICC markets for non-banks and internationally?

The Investment Association welcomes the BSRC's proposals to develop a process by which banks can assess and improve their standards of behaviour and professionalism against a common network.

However, the success of these proposals will depend on the extent to which the banks engage with it, as minimal participation will reduce the effectiveness of any standard framework.

Once the initiatives have been established for banks, it could be considered whether it is appropriate for it to be extended to other FICC market participants and internationally.

Regulatory initiatives to improve governance and incentives

39. Are there other regulatory measures the authorities could take to strengthen personal accountability or otherwise improve the way firms manage incentives and governance? In particular, should any or all of the measures in the Senior Managers and Certification regime be extended to non-bank firms active in FICC markets?

We have concerns with the approach proposed by the FCA/PRA on the Senior Manger regime and the Remuneration Code.

We are in principle, supportive of individual accountability. However, the regulatory regime should not deter well-qualified and motivated people from taking senior positions in banks. It is critical that the structure enables effective delegation, as opposed to requiring micromanagement from executives by effectively imposing strict liability on senior persons. The regulatory framework should encourage professional responsibility at all levels so that:

- Some junior staff would end up having a responsibility broadly analogous to that of, for example, junior solicitors. They would not be primarily responsible for providing advice to clients, but nonetheless they should have the responsibilities of a professionally qualified individual
- Senior persons would have overall responsibility for processes and conduct within their areas, but they should focus on effective delegation and control rather than the micromanagement of every decision. If the latter were to be the case, decision-making and appropriate risk-taking might become paralysed within the organisation, with executives seeking to avoid responsibility for the judgments they are employed to make this would be wholly counterproductive and lead to a culture of buck-passing. It is important that senior persons put in place arrangements to manage the risks within their areas of responsibility, but they cannot be expected to achieve zero failure operations.

Banks have always been and, need to remain, risk-taking businesses and any regime that risks paralysis of decision-making or the appropriate exercise of executive authority should be avoided.

We are concerned with the enforcement regime and in particular the fact that under the new regulatory framework there is a presumption of responsibility, under which Senior Managers will have to satisfy regulators that they have taken 'reasonable steps' to prevent or stop a contravention. This reversal of the burden of proof (presumption of innocence) is wrong in principle: the burden should be no different from the normal criminal standard.

Banks need to attract and retain appropriate talent as both Executives and Non-Executives. We are concerned that the reversal of the burden of proof will limit the ability of banks to attract high quality Directors and senior managers of banks.

As stated above, The Investment Association welcomes shareholder and firm efforts to improve the incentive framework within firms, and to strengthen the long-term alignment between Executive bank remuneration and shareholder value. However, The Investment Association would be concerned that prescriptive regulatory proposals to mandate the length of deferral periods, and create overly complex incentive arrangements, could have unintended negative consequences. Such proposals could have the effect of decreasing the perceived value of variable remuneration, and consequently, given the competitive pressures on the banking industry and the need for banks to compete globally for talent, could result in increases to fixed, non-performance related, non-forfeitable pay. Mandated adjustments of performance measures, such as the banning of profit-based measures unless part of a balanced or risk-adjusted scorecard, can be considered a blunt mechanism for taking account of risk.

For these reasons we are concerned with the introduction of the PRA/FCA proposals for Banks and this would include extension to other non-bank firms.

The differences between the banking sectors and non-banking sectors means that The Investment Association would not support the extension of the measures in the Senior Managers and Certification regime. Non-banking firms are already covered by relevant legislation, such as AIFMD and UCITS V for asset managers.

The Investment Association considers that the most effective tool for addressing governance and incentive deficiencies in FICC markets is better adoption of implementation by firms of strong codes of practice.

Surveillance and penalties

40. What role can more effective surveillance and penalties for wrongdoing play in improving the fairness and effectiveness of FICC markets globally? How can firms and the industry as a whole step up their efforts in this area? And are there areas where regulatory supervision, surveillance or enforcement in FICC markets could be further strengthened?

In order to strengthen the fairness and effectiveness of FICC markets, surveillance methods must be strengthened, both by the regulator and within the firms themselves. Firms should both build up stronger codes of practice, and ensure they are communicated to the wider workforce. If these codes of practice are sufficiently strong and well-defined, it will be easier to see where an individual's actions fall outside the best practice framework.

Firms must work together, both nationally and internationally, to improve surveillance within the industry as a whole. One example in which better communication between firms is needed relates to problematic individuals who move from firm to firm, spreading bad behaviours as they go. Improved communication between firms could see these individuals identified early on, and prevent them from bringing poor standards of practice to new firms.

Regulators' attempts to monitor FICC markets have been hindered by a lack of reliable data. Firms involved in FICC markets could improve the surveillance framework by providing more, and better data to regulators.

Firm level surveillance

41. How can firms increase the effectiveness of their own surveillance efforts across FICC markets globally? What role could the industry play in helping to explore best practices on how to make whistleblowing and other similar regimes more effective? Is there scope to make greater use of large scale market data sets and electronic voice surveillance to help detect cases of abuse in FICC markets? Are there other potentially effective tools?

The Investment Association would welcome any efforts by firms to improve their own surveillance efforts. In terms of whistleblowing, this could include wider-spread use of whistleblowing hotlines, although firms must demonstrate that they are taking steps to act on whisteblower complaints, as previously this has not been the case.

While some data will always remain confidential, firms, as well as regulators, would benefit from more widely available large scale market data sets in order to establish where risks lie, and to detect where firms' standards are below that of the industry.

Increased electronic voice surveillance can be an effective tool, although it must be used alongside a variety of other surveillance methods, and within an effective preventative framework.

Firm level penalties

42. Are there processes or structures that can allow firms to punish malpractice by their own staff more effectively (for example, penalties for breaching internal guidelines)?

Firms must play a role in penalising poor behaviour. This must include not only behaviour which contravenes regulation, but also behaviour which contravenes the firm's own internal guidelines. Prior to the crisis, some companies proved ineffective at disciplining individuals who brought in high profits even where the risk profile was unacceptably high. This often had severe negative effects for firms over the long-term.

43. 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?

Ideally, firms could implement market discipline by shifting business away from firms with poor standards. However, the concentration of the FICC market can make it difficult to pull business, as it increases the counterparty risk exposure of firms that choose to do so.

Poor behaviour should be reported to the relevant authorities. However, some members have reported fears that in reporting such behaviour they open themselves up to investigation and accusations that their control systems were sub-standard.

We discuss this in more detail with our response to question 17.

Regulatory level surveillance and supervision

44. Is the current supervisory approach and level of intensity dedicated to supervising conduct within the UK wholesale FICC markets appropriate?

We consider the current risk-based approach to supervision to be the most appropriate way to utilising regulatory resources without imposing undue burden on financial market participants.

45. Are there ways to improve the data on FICC market trading behaviour available to the FCA, whether through the extension of the regulatory perimeter or otherwise?

Regulators should not impose additional data requirements until such time that they have had an opportunity to assess the adequacy and coverage of the new data that they will receive as a result of the implementation of MiFID that will significantly increase market transparency and regulatory reporting.

Regulatory-level penalties

46. What further steps could regulators take to enhance the impact of enforcement action in FICC markets?

The Investment Association is supportive of any appropriate reforms of bank regulation which could improve the fairness and effectiveness of FICC markets. However, we do have concerns regarding the prescriptiveness of proposals to strengthen the regulatory framework for individuals. Banks are, and need to remain, risk-taking businesses, and investors will need adequate investment returns if they are to remain consistent providers of debt and equity capital for banks.

Recent proposals requiring senior bank personnel to prove their adherence to a list of responsibilities could have the effect of 'paralysing' senior managers, making them unwilling to take necessary risks for fear it could lead to prosecution. It could also encourage micro-management from senior management, who would fear that any delegation of responsibilities could be seen as an abrogation of duty.

In order to ensure that markets remain effective, caution should be taken before overly proscriptive regulatory changes are made.

FINRA's licencing requirements in the US provide an interesting example that would merit further consideration. Under this regime, individuals who deal with the public (e.g. retail brokers) are required to be licensed. This includes taking exams (e.g. Series 7) and being finger-printed in order to become a "registered representative". In the event a registered representative leaves a firm, the employer is required to fill out a Form U5 stating the reason for termination (voluntary, involuntary, cause, etc.). This is a permanent record that stays with the individual over the course of their career. This information is stored in a central database – BrokerCheck – that can be accessed by regulators.

This approach provides a vehicle for more targeted enforcement at the individual level and helps future employers and regulatory supervisors assess risk. A potential employer can look at the individual's industry record and decide if this person is a good fit for the organisation. Likewise, if a large number of problematic employees are hired at a single employer this could trigger closer supervision.

47. Should consideration be given to greater use of early intervention, for example, temporary suspension of permission for a particular trading activity for firms or individuals or increased capital charges?

Capital charges and penalties to a firm hurt shareholders and investors. Consequently, we recommend that penalties should be tailored to individual conduct, making individual penalties far more appropriate than capital charges. Firms that fail to respond to repeated employee misconduct could be considered for greater regulatory scrutiny.

48. Is there a need to widen and or strengthen criminal sanctions for misconduct in FICC markets?

Regulators should be cautious about making the punishments so severe that financial markets no longer serve as an area to foster innovation, appropriate risk taking, and economic growth. Severe penalties will deter qualified individuals from entering the financial sector and from exploring potentially rewarding opportunities.

49. Is the approach set out in the Criminal Sanctions Market Abuse Directive appropriate for the United Kingdom? Are there additional instruments or activities to those envisaged by the Directive that should be covered by the domestic criminal regime?

The Investment Association notes that the UK's Bribery Act 2010 contains many of the same provisions as CSMAD, while allowing for greater flexibility.

In particular, CSMAD allows for the imposition of criminal penalties on a corporate, without provision for mitigants such as an 'adequate procedures'. This could potentially have serious, and unintended consequences, whereby a firm can be severely punished for the actions of an individual, even where it has taken strong steps to avoid such an occurrence.

In general, The Investment Association welcomes international co-operation on surveillance and sanctions.

Appendix A

The Investment Association's Special Committee Terms of Reference

The Investment Association actively encourages members to join a Special Committee, when invited to do so, not only to protect the value of their investments but to foster best practice and a culture of active creditor engagement in the corporate bond market.

The success of The Investment Association Special Committee process is wholly dependent on The Investment Association's members willingness to participate in the process and to go off market when required.

Introduction

- Special Committees are formed at the request of issuers, in conjunction with their financial advisers.
- They are formed to consider firm proposals from issuers and are not intended to be used by issuers for market testing.
- Special Committees are also formed at the request of investors where they are concerned about the underlying value at risk.
- Invitations to participate in a Special Committee are based on an assessment of investors' holdings of the relevant securities either from:
  - a register of holders, or;
  - a holdings enquiry conducted by The Investment Association.
- Each Special Committee will be formed to represent the interest of investors in particular securities (the "Reference Securities") within an issuer's capital structure. By joining the Special Committee, participants confirm that, where they hold securities issued by the issuer other than the Reference Securities ("Non-Reference Securities"), they will only act on the Special Committee to advance their interests in respect of the Reference Securities.
- In the circumstances, where participants in the Special Committee of the Reference Securities hold enough Non-Reference Securities within the Issuer's capital structure to participate in another Special Committee being formed at the request of the Issuer, The Investment Association may form a separate Special Committee to act to advance the interests of the holders of the Non-Reference Securities.
- Such a Special Committee will be staffed by different The Investment Association's personnel to the Reference Securities Special Committee and will in all respects remain separate from the Reference Securities Special Committee.
- Special Committees considering relatively simple proposals are usually composed of 3 to 4 investors.
- Special Committees considering proposals covering several financial instruments or special purpose financial structures may be larger in order to provide appropriate cover of the investor base.
- Special Committees are generally composed of The Investment Association's members whose aggregate holdings represent a significant proportion of the outstanding securities in question.
- The objective is to assemble a group of investors whose aggregate holdings are such that the Special Committee's opinions will merit serious consideration by its peers in the investor community.

Many, but not all, of the proposals presented to a Special Committee will contain price-sensitive information.
Investors should consider on an individual basis the timing and precise arrangements by which they take themselves inside or off market when deciding whether or not to participate in a Special Committee.

Role of The Investment Association

The Investment Association acts as the secretariat to the Special Committee. As part of this The Investment Association will:

1. Conduct holdings enquiries at the request of issuers, or at the behest of an investor, ahead of deciding whether it is feasible to form a Special Committee.
2. Ensure that all holdings are disclosed to the issuer on an **aggregate basis only**, unless **express written consent** has been granted by **all** the participants of the Special Committee that their individual holdings can be disclosed.
3. Receive written confirmation from the issuer and its advisors on how it intends to cleanse participants where price sensitive information is provided to the Special Committee ahead of inviting investors to sit on a Special Committee.
4. Invite investors to sit on a Special Committee.
5. Arrange meetings of the Special Committee and circulate any materials ahead of the meeting.
6. Conduct all meetings on a Chatham House Rules basis.
7. Provide feedback to the issuer and its advisors on behalf of the participants of the Special Committee.

In certain circumstances, an issuer may want to present proposals that encompass more than one security with differing economic interests. In any such instance, The Investment Association will consider forming separate Special Committees to represent these different economic interests.

Terms of Reference for Special Committees

1. To consider an issuer proposal that requires an investor vote. .
2. To assess the proposals from the viewpoint of both the criteria adopted in their own investment houses and what would be acceptable to the wider market.
3. To provide feedback to issuers and advance counterproposals, where appropriate.
4. To issue opinions on a unanimous basis. Where this is not possible, the decision of the majority of the Special Committee, based on percentage holdings, will prevail.

Withdrawing from a Special Committee

1. When agreeing to participate in a Special Committee, investors should do so on the basis they remain actively engaged until the process has reached its natural conclusion.
2. Where an investor is not willing to support a proposal, it is encouraged to continue participating in the Special Committee until its conclusion as its involvement and views may continue to add value to the overall outcome for all investors.

3. Any investor seeking to withdraw from a Special Committee mid-negotiation should only consider doing so under exceptional circumstances, as doing so may negatively affect the structure of the Special Committee, its reputation and process.
4. When withdrawing from a Special Committee, the investor should inform the Special Committee, in writing, of the reasons for its withdrawal.
5. If the withdrawing investor has been in receipt of inside information, it should use reasonable endeavours to ensure that it has been cleansed of the information as agreed at the beginning of the Special Committee process.

Note

1. There is no obligation on any investor to participate in a Special Committee when invited to do so.
2. There is no obligation on any individual Special Committee to reach a consensus on the proposal placed before it.
3. There is no obligation on any of The Investment Association's member to act in accordance with the Special Committee's opinion.
4. Given the differing investment objectives of various types of funds, Special Committees are under no obligation to provide an opinion in relation to the pricing level for partial redemptions.

For issuers and their advisors

Issuers and their advisors should aim to:

1. Provide properly-worked proposals for review and avoid using the Special Committee process for the purposes of market testing potential proposals.
2. Inform The Investment Association if the proposals that will be presented to the Special Committee encompass more than one security with differing economic interests. This will provide The Investment Association with an opportunity to consider forming more than one Special Committee.
3. Inform the Special Committee if, to the best of their judgment, proposals covering fixed-interest instruments are expected to have a material impact on equity valuation.
4. Ensure that the length of time that investors are 'off-market' due to participation in a Special Committee is kept to a minimum. Issuers should be prepared to provide the Special Committee with an indication of how soon the process will be concluded.
5. Cleanse the Special Committee by informing it when the company publishes its proposals or considers that an agreement cannot be reached and therefore consultations should be formally closed.
6. Ensure that any costs incurred by The Investment Association as part of the Special Committee process are paid, irrespective of the voting outcome.