REGULATORY RISK UPDATE

THE FAIR AND EFFECTIVE MARKETS REVIEW RECOMMENDATIONS TO STRENGTHEN UK REGULATION OF FICC MARKETS AND INDIVIDUAL ACCOUNTABILITY

INTRODUCTION

In the wake of a number of recent high profile LIBOR and Forex market abuses, the Chancellor of the Exchequer and the Governor of the Bank of England established the Fair and Effective Markets Review (**"FEMR"**) in June 2014 to assess the operation of the wholesale Fixed Income, Currency and Commodities (**"FICC"**) markets. The aim of the FEMR was to help restore trust in those markets by seeking to improve market conduct.

HM Treasury and the FCA have already implemented the FEMR's recommendation to bring seven key benchmarks (in addition to LIBOR) within the scope of regulation. ISDAFIX, Sterling Overnight Index Average (SONIA), Repurchase Overnight Index Average (RONIA), WM/Reuters (WMR) 4pm London Closing Spot Rate, London Gold Fixing, LMBA Silver Price and ICE Brent Index were bought within regulatory scope with effect from 1 April 2015.

On 10 June 2015, the FEMR published its Final Report, setting out its findings of FICC market practices and made 21 recommendations. The FCA published a statement welcoming the latest recommendations, stating *"[p]utting good conduct and accountability at the heart of these vital global markets will safeguard their future integrity, and the UK's pre-eminent position in them."*

The FEMR found that as unethical behaviour went unchecked, it became progressively more widespread and accepted as the norm. However, the FEMR also noted that substantial progress has been made in addressing these deficiencies through legislative reforms such as amendments to the Market Abuse and European Market Infrastructure Regulations (**"MAR"** and **"EMIR"**) and the new Markets in Financial Instruments Directive and Regulation (**"MiFID II"**) and clarification/strengthening of market practices as well as major enforcement actions carried out internationally.

The FEMR, however, also noted a number of gaps remain and its recommendations are designed to fill those gaps. Its 21 recommendations are designed to:

- raise standards, professionalism and accountability of individuals;
- enhance UK regulation of FICC markets;
- improve the understanding of trading practices in the FICC markets;
- launch international action to raise standards in global FICC markets;
- promote fairer, and enhancing effectiveness of, FICC market structures; and
- improved conduct risk identification and mitigation.

Firms operating in the FICC markets should review the findings and consider how the recommendations are likely to affect their business. Further details of key findings and recommendations are set out below.

KEY FINDINGS

The FEMR identified the following areas as being the root causes of the misconduct in recent years, which have contributed to an "*ethical drift*":

- market structures which presented opportunities for abuse, including poor benchmark design, unmanaged conflicts of interest (intermediaries acting as both principal and agent), vulnerabilities to collusion and thin markets for less liquid assets;
- standards of acceptable market practices lacking detail or teeth and were poorly understood or adhered to (particularly in less heavily regulated/unregulated instruments such as spot FX);
- systems of internal governance and control which placed greater reliance on second and third lines of defence than on trading or desk heads, which did not effectively assert interests of firms or the wider market over close relationships between trading staff, and which did not identify emerging risks or ensure that "lessons learnt" in one area were applied elsewhere;
- limited reinforcement of standards through bilateral market discipline;
- remuneration and incentive schemes which promoted short-term returns over longer-term value enhancement and good conduct; and
- a culture of impunity.

KEY RECOMMENDATIONS

The FEMR considers that the following steps will address what it sees as remaining gaps not addressed by reforms already underway - a focus on individual professionalism and accountability; agreeing and adhering to common standards of market practice: gaps in regulatory coverage; and raising standards in global markets.

Individual accountability

- Develop common global standards for trading practices in FICC markets. This dovetails with a separate recommendation focused specifically on FX calling for a global FX Code (see below);
- Establish new training and qualifications standards (including continuing professional development) for FICC market personnel. Guidance on minimum standards will be provided by a new FICC Market Standards Board (**"FMSB"**) (see below). While this recommendation focuses on FICC market personnel in the United Kingdom, it is likely to have flow on ramifications for personnel in other jurisdictions, particularly given the global nature of FICC markets and that a number of such personnel move between jurisdictions;
- Mandate detailed regulatory references to help firms prevent the 'recycling' of individuals with poor conduct records between firms, which must include, among other information, details of any disciplinary action taken in the past five years to address a breach of the FCA conduct rules.   It will be interesting to see how rules and guidance develop to protect firms from employment claims by employees who have been given such references;
- Extend UK criminal sanctions for market abuse to a wider range of FICC instruments. It should be noted that there is already a criminal offence for making false or misleading statements or creating a misleading impression in relation to relevant investments and benchmarks; and
- Lengthen the maximum sentence for criminal market abuse from seven to ten years' imprisonment.

Enhancing UK regulation of FICC markets:

- Create a new statutory civil and criminal market abuse regime for spot foreign exchange;
- Ensure proper market conduct is managed in FICC markets through monitoring compliance with all standards, formal and voluntary, under the proposed Senior Managers and Certification Regimes for UK deposit-taking institutions and PRA-regulated investment firms who have permission to deal as principal;
- Extend elements of the Senior Managers and Certification Regimes to a wider range of regulated firms active in FICC markets. However, the FEMR did not consider it appropriate to extend the presumption of responsibility under the Senior Managers Regime (the senior person is required to prove, on the balance of probabilities, that they are not guilty of misconduct and that they took all reasonable steps in order to prevent it happening) to non-bank entities; and
- Improve firms' and traders' awareness of the application of competition law to FICC markets.

Improve quality and understanding of trading practices in the FICC markets:

Creation of a new FMSB, with participation from a broad cross-section of global and domestic firms and end-users to scan for and report on emerging risks, provide guidelines for areas of uncertainty in specific trading practices, promote adherence to standards and contribute to international convergence of standards. While initially UK based, it is intended the FMSB have international reach through its membership and by working with similar organisations in other jurisdictions.

Launch international action to raise standards in global FICC markets:

According to the FEMR, there should be a single global FX code (building on the global preamble released by central banks in March 2015), which provides a comprehensive set of principles to govern trading practices around market integrity, information handling, treatment of counterparties; and detailed examples and guidelines for expected behaviours. The Bank of International Settlements has already announced that it will take this work forward via its Markets Committee. FEMR also recommends various measures for improving controls and transparency around FX market practices, such as consistent provision of time stamps and standards governing "last look" practices. International action should also ensure benchmark administrators publish more consistent self-assessments against the IOSCO Principles.

NEXT STEPS

Some of the recommendations require further discussion, international negotiation or legislative change (where required, formal cost/benefit analyses will need to be completed for changes requiring public consultation). The FCA confirmed in its statement that the recommendations do not change its current rules, but that where recommendations call for changes in regulation, the FCA will consult on how to implement these changes with the Bank of England, HM Treasury, the Competition and Markets Authority and international regulators as appropriate.

An open forum will be held in in autumn 2015 to provide an opportunity for stakeholders to discuss the recommendations and research themes in the Final Report. The Chair of the FEMR is required to provide a full implementation update to the Chancellor of the Exchequer and the Governor of the Bank of England by June 2016. There is significant impetus among regulators both in the UK and globally to effect change in FICC market conduct, so we can expect to see substantial continued regulatory activity in this area over the coming year and beyond, with a series of practical ramifications for the day to day operations of FICC markets around the world.

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