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Cause and FX: the key judgements in the UK Fair and Effective Markets Review

Summary

The UK Fair and Effective Markets Review (FEMR) was conducted jointly by the Bank of England, the UK FCA Conduct Regulator and the UK Treasury and released its recommendations on June 11. It was launched in the wake of the LIBOR scandal by Bank of England Governor Mark Carney as a major contribution to the UK political and policy debate around the conduct of traders in UK FICC markets. Where much of the first wave regulatory responses to the 2008 crisis in the UK focused on good and bad structures, FEMR has explicitly and largely exclusively addressed conduct and personal accountability. It tweaks the conventional UK approach to wholesale market self-regulation, beefs up sanctions and makes a serious bid for a global code of conduct for FX markets.

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Where much of the first wave regulatory responses to the 2008 crisis in the UK focused on good and bad structures, FEMR – via the LIBOR scandal – has explicitly and largely exclusively addressed conduct and personal accountability. While the UK Chancellor George Osborne has publically declared the end of hostilities between the UK government and the banking industry, the UK regulator has clearly judged that London's reputational capital still requires remedial action. The result is a recommended mix of rejigged self-regulation, tougher sanctions and more intrusive oversight and intervention.

In time FEMR will shake up training, certification and qualification systems for FICC traders operating in London. But the FEMR is potentially important outside of the UK because its calls expressly for its recommendations to contribute to the global development of a code of conduct for FX markets via IOCSO, BIS and the FSB. Generally this would be read as a tacit shot for the long grass rather than a serious concern about arbitrage, but not in this case. UK influence in these bodies - Carney himself chairs the latter - means that London takes this internationalisation seriously. So beyond these points of practical and technical detail there are also a number of general judgements embedded in the FEMR that are worth noting.

Standards and sanctions

The first is the conclusion that FICC markets have a conduct problem rather than a structural one. FEMR set itself a wide remit to review market structure, especially thin markets, the power and potential conflicts of OTC market makers and a potential lack of competition between big vertically integrated players. However there was nothing in its final recommendations on structure. For now the UK authorities have judged that EU regulations such as the European Market Infrastructure Regulation (EMIR) and the Market in Financial Instruments rules on disclosure and transparency need to work through the system before a judgement can be made. The biggest 'structural' change is the scope of regulation and sanctions themselves. Back in November 2014 the FEMR review proposed widening the benchmarks covered by the new LIBOR oversight regime to sterling overnight rate indexes and six other benchmarks including gold and Brent oil prices. This has already been done.

The second is the extent to which it largely gives up on the 'conventional' regulatory assumption that sophisticated wholesale market buyers are capable of policing market practice themselves through their choice of counterparty. FEMR makes little reference to buyer power in large part because end-user respondents to the review seem to have been clear that they do not really have it or exercise it. In this sense, FEMR marks the end of any real presumption in favour of the wholesale customer's power to dictate vendor behaviour. This is not however a rejection of self-regulation – the FEMR is in fact very heavy on new market codes of professionalism and peer review. Albeit backed up with tougher statutory sanctions for misconduct.

In this respect FEMR broadly proposed two kinds of things. The first is a set of conduct standards and enforcement mechanisms for the UK market. Industry and end-users have been asked to set up a FICC Market Standards Body (FMSB) to monitor market developments, identify future risks and propose training and qualification systems for FICC traders. FICC market participants will also be brought into the UK's new Senior Managers regime for pre-approval and professional certification. For enforcement, criminal sanctions for FX Spot market manipulation have been proposed, as have longer maximum sentences for market misconduct,

FEMR Key recommendations	
Higher standards of personal accountability in UK FICC markets	▪ A new common set of written standards for trading practices for UK FICC professionals. ▪ A new FICC Market Standards Body formed by industry to develop qualification and training standards for UK FICC traders. ▪ Compulsory regulatory CVs for all UK FICC traders, flagging past misconduct to future employers. ▪ The extension of maximum criminal sentences for market misconduct from seven years to ten (to align with other fraud sanctions). ▪ Extension of new UK certification and pre-approval rules for 'Senior Managers' extended to asset managers, AIFM managers, hedge funds and interdealer brokers. ▪ New criminal code for spot FX markets (to fill the gap left by the MAR)
Expanded oversight of FICC markets	▪ Extend LIBOR framework to seven other benchmarks including SONIA, RONIA, gold, silver and Brent Crude (already completed November 2014).
Global action on FICC standards and protocols	▪ Global FX code: comprehensive principles for trading practices, new rules on transparency and controls against misconduct ▪ Further FSB assessment of links between remuneration and conduct risk.

essentially bringing them into line with sanctions for fraud. FEMR also proposes that FICC traders should have ‘regulatory CVs’ that force disclosure of past misconduct to employers – an idea already endorsed by the New York Federal Reserve.

London and the rest

The UK authorities have clearly recognised that London defining FX market standards unilaterally makes little sense, so FEMR proposes work on a global code of practice for FX trading practices and standards for venues. This would build on the Global Preamble adopted by the largest FX Committees in March 2015 and would be overseen by IOSCO, BIS and the FSB. The proposed balance at the international level mirrors that suggested for the London market: a clearer code of conduct backed up by sanctions - loss of membership of an FX Committee for firms in breach, for example. The FEMR has also suggested that global regulators should look again at the link between remuneration and market conduct and make fresh recommendations on the link between fixed and variable pay.

Unlike many such calls for such international coordination, the decision to push for a global code reflects London’s intent to deliver new standards rather than defer them. Likewise, the opting for less complex agreement on a new code rather than new regulation. With the Chair of the FSB and London’s trading weight behind it, the FEMR calculates that agreement will be possible. Indeed, the FEMR predicates the desired creation of a statutory regime for market abuse in FX on a preceding agreement at the global level codifying standards on issues such as last look and frontrunning. However, even the drafting of a global code will not necessarily be simple. Wide agreement on the status – and definition - of frontrunning and ‘last look’ in FX markets will not necessarily be simple.

The role of the EU is also an open and interesting question. The UK’s market abuse framework was itself reshaped by the EU’s response to the benchmarks issue in 2013/14, but London’s implicit suggestion in the FEMR is that there is no specific role for Brussels in FICC conduct regulation. This is characteristic of London. But recent UK experience of pursuing its own preferences on changes that ultimately emerge in a European variant – on the Retail Distribution Review, or more recently on Bank Structural Reform, for example – presents something of a lesson in the capacity of Brussels to pose problems for unilateral UK reform.

FEMR acknowledges that European regulation is driving structural change for FICC market venues, but it does not see a European role beyond that. Either this presumes that Brussels will see no opportunity for embedding FSB principles in EU regulation, or putting a European spin on them. Or it presumes that whatever the UK might have done in the interim in toughening or defining standards will be consistent with whatever ultimately emerges from Brussels. The UK’s dominant share of the global forex market (41% at the time of the last BIS triennial review in late 2013) may simply have convinced the FEMR experts that there is no scope for a separate European view. All three assumptions represent a good case for watching the alignment of London and Brussels on these questions closely.

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