Morgan Stanley

Bank of England
Threadneedle Street
London EC2R 8AH

HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Financial Conduct Authority
25 The North Colonnade
London E14 5HS

Dear Sirs

Re: Response to the Fair and Effective Markets Review (October 2014 consultation)

We appreciate the opportunity to respond to the October 2014 consultation document. While Morgan Stanley has worked with several industry associations to assist in responses reflecting broad industry views, we recognise the importance of the work undertaken by The Fair and Effective Markets Review (the "**Review**") and the need for individual market participants to provide feedback in order that the Review achieves its intended goals.

We acknowledge the need for a review of the fairness and effectiveness of the FICC markets, in light of the various misconduct cases noted in the consultation, and in order to address perceptions, and in some cases misperceptions, about these markets and their participants. We appreciate the balanced and constructive nature of the consultation, and the recognition of the challenges in providing solutions for the issues raised. We trust that the Review's work will contribute to a proportionate response which is sensitive to the individual features and nuances of the FICC markets.

The Review has set out a framework for the key characteristics that contribute to the fairness and effectiveness of FICC markets. Achieving this will require a successful balance of regulation, market practitioner-led codes and standards, and strong culture and controls within market participant institutions. The latter of these is, we believe, the essential foundation, contributing to the successful compliance with rules and standards and appropriate conduct. Strong culture and controls throughout the FICC markets should complement and underpin a framework of regulatory and market-led standards.

We also want to acknowledge up front that post-crisis regulatory changes were necessary, and we have been, and continue to be, supportive of those changes. We welcome the opportunity to continue to take part in the work of the Review. Our response to the consultation is thematic and targeted at the following key issues: the characteristics of fair and effective markets; the importance of liquidity and market-making; liquidity issues in certain government bond and corporate bond markets; the related and important role of transparency; and our thoughts on conflicts management as well as market standards.

A. The Review's proposed characteristics of 'fair and effective' markets

We welcome the Review's focus on the effectiveness of FICC markets. The capital markets are of fundamental importance to economies and to supporting the growth and development of corporate issuers, government funding requirements, and the investment needs of all types of investors. The need to increase further the role of capital markets in channeling funding to the economy is the key objective of the European Union's plan to build a Capital Markets Union. Liquidity is an important foundation for thriving capital markets which themselves support efficient capital allocation, economic development and the creation of jobs.

The Review requests respondents' views on its proposed definitions of 'fair and effective' FICC markets. While we agree with the Review's proposed definitions and characteristics, we would emphasise the following thematic issues:

- Effective markets are those which enable investment, funding and risk transfer in *volatile* as well as benign market conditions.
- We are supportive of the current and planned regulatory reform agenda. As regards the calibration of regulation, a healthy ongoing dialogue between market participants and regulators is essential, given the potential for regulation to harm as well as enhance the liquidity and effectiveness of markets.
- Fair dealing and disclosure should allow all market participants to understand and manage risk, providing certainty around the apportionment of risks for all parties and enabling informed risk/reward decisions to be made in dealings with market-makers and intermediaries. This principle underlies our views on issues such as conflicts management and transparency.

B. The effectiveness of the FICC markets

1. <u>The importance of liquidity and the role of market-makers</u>

The Review references the sufficiency of liquidity and resilience of FICC markets when discussing their effectiveness and the key characteristic of "*allow[ing] end-users, borrowers and end-investors to undertake transactions, including risk transfer and the channeling of savings to investment in a predictable way, in support of the broader non-financial economy.*" We agree with this definition and the importance of appropriate levels of liquidity as a hallmark of effective markets. While the Review notes that more liquidity is not always better and that excessive liquidity provision may harm markets, we should be equally concerned with a state of insufficient liquidity. Post-crisis regulatory and market-led reforms have been effective in reducing activities which may have been signs of excessive liquidity. However, there are now growing concerns regarding the availability of necessary liquidity in core FICC markets, particularly in periods of market stress, and signs of increasing fragility.

While the Review acknowledges that liquidity in some FICC markets is noticeably lower since the financial crisis (pointing to a number of factors, including capital regulation), it also states that it is not clear whether the changes will reduce liquidity in the long run. We believe there is significant cause for concern regarding the current and future liquidity levels in the government and corporate bond markets. These concerns are discussed by the U.S. Treasury Department's Office of Financial Research (the "**OFR**") in its 2014 Annual report.[1] The OFR notes the potential fragility of liquidity during market shock periods and the contributing factor of reduced willingness or capacity of market-makers to provide liquidity, citing the dislocation in the U.S. Treasury markets in mid-October 2014 as a recent example of where this may have exacerbated market dislocation.

Traditionally, reliable liquidity provision has been the province of regulated banking entities acting as market-makers in the FICC markets. The importance of the role of market-makers in the FICC markets is recognised by the Review and by the Committee on the Global Financial System ("**CGFS**") in its recent study group report "*Market-making and proprietary trading: industry trends, drivers and policy implications*".[2]As noted by the CGFS, a key role of market-makers is to "*contribute to the robustness of market liquidity by absorbing temporary supply and demand imbalances, dampening the impact of shocks on market volatility and quoting prices to support investors in valuing assets*." This *absorption* of supply and demand imbalances (i.e. the ability of market-makers to warehouse inventory and manage associated risks) is critical to the proper functioning and effectiveness of markets.

Also in its report the CGFS makes observations regarding the deterioration of market-making activity, the decline in dealer risk-taking capacity/willingness, and market-makers narrowing the scope of their services, alongside a growing and more concentrated demand for market-making services[3]. We believe there are several factors impacting the current level of liquidity. Market-makers are now forced to manage their businesses under significant financial constraints and there is no question that these changes have caused them to shrink their balance sheets by decreasing their overall market-making inventory. The net effect of these changes has been, and will be, a significant reduction in market-making capacity, not only at individual firms but in aggregate across the industry. The CGFS notes that: '*With the cumulative effects of the newly emerging regulatory environment and other structural changes still uncertain, policymakers may also want to keep track of the combined impact on the effectiveness and robustness of market-making arrangements*.'[4] We believe that the CGFS is right to encourage policymakers to review the impact of regulatory changes on the robustness of market-making, and some targeted

---

[1] http://www.treasury.gov/initiatives/ofr/about/Documents/OFR_AnnualReport2014_FINAL_12-1-2014.pdf - p.6.
[2] http://www.bis.org/publ/cgfs52.pdf - p.5.
[3] http://www.bis.org/publ/cgfs52.pdf - p.20 and p.33.
[4] http://www.bis.org/publ/cgfs52.pdf - p.3.

recalibrations might be beneficial (without sacrificing the overall intent of the regulatory framework).

While reduction in traditional market-making capacity may be counterbalanced by new liquidity providers, the CGFS is cautious about the ability of such providers to continue providing market-making services in more stressed conditions, and a general shift in market-making to less regulated market participants.[5] We echo this caution.

Compounding the reduction in overall market-making capacity is the fact that market-makers are unlikely to dedicate their balance sheet resources to clients on a pro rata basis. As a result, some clients may no longer have access to the liquidity they need. In order to get that access, we have started to see, and would expect to see more, that smaller firms are consolidating their funds with the largest asset managers. These large asset managers in turn are noting the lack of liquidity to execute their largest trades and are expressing greater concerns about market liquidity.

Against this backdrop of reduced market-maker capacity, we discuss below some specific observations on the government and corporate bond markets.

2. Government bond markets

We believe the single biggest constraint on liquidity in the government bond markets is the Basel leverage ratio. The existing calibration of leverage ratio calculations is already having, and will continue to have, a negative impact on liquidity and on the effectiveness of primary and secondary government bond markets. We believe appropriate adjustments could improve liquidity and the effectiveness of markets, without risking instability of liquidity providers.

The calibration of the leverage ratio represents a significant challenge for government bond primary and secondary market-making activities in core low risk markets such as France, Germany, the UK and the U.S., imposing what could well be considered a disproportionate tax to an asset class with very low risk, and hence, very low margins. A requirement to hold 5% equity against low risk government bonds may present an almost insurmountable hurdle to providing shareholders with an acceptable return on capital (in a market environment where, for example, 10-year Bunds yield 50 basis points), and hence a barrier to entry and a competition/market concentration issue.

We mention above the comments of the OFR regarding the potential for reduced market-making capacity to be a contributing factor to the fragility of markets in stress periods. We note that the OFR makes specific mention of the U.S. Treasury market dislocation in mid-October 2014 and cites reduced market-making capacity as a potential contributing factor,[6] a possibility also recently acknowledged by Governor Jerome H. Powell of the Board of Governors of the Federal

[5] http://www.bis.org/publ/cgfs52.pdf - p.35.
[6] http://www.treasury.gov/initiatives/ofr/about/Documents/OFR_AnnualReport2014_FINAL_12-1-2014.pdf - p.6.

Reserve System.[7] While more analysis will be required to determine exactly how different factors impacted markets during this period, reduced market-making capacity does seem to have exacerbated the shock to the markets.

We recognise the challenges involved in any recalibration of the leverage ratios, but believe it is essential for the treatment of low risk government bonds to be adjusted if necessary levels of primary and secondary market liquidity are to be maintained. We suggest that appropriate leverage ratio carve-outs for market-making related government bond holdings would be prudent and beneficial to markets.

We would be happy to discuss these issues further with the Review, and to provide some additional background information.

3. Corporate bond markets

We fully understand the concerns of some market participants regarding illiquidity in the corporate bond markets and have a continuing dialogue with our clients on the subject. We support the interests of a broad client base, and recognise the range of interests among clients, including large asset managers concerned about effective secondary market liquidity, buy-to-hold investors, and issuers looking to raise and manage funding in a stable and cost effective manner.

The number and heterogeneity of issuances in the corporate bond market is a long-standing feature, resulting from the bespoke nature of issuer funding and/or investor asset profile requirements. Investor holdings and trading activity are broadly dispersed across a wide range of distinct securities, resulting in fragmented trading and difficulty in migration to electronic venues. This inherent asset illiquidity is compounded by the following factors:

- reduced dealer balance sheets;
- overall growth in the outstanding volume of corporate debt, a trend which looks set to continue given constraints in the corporate loan markets and further quantitative easing; and
- buy and sell-side concentration, an issue recognised by the CGFS, commenting that "*One implication of further concentration would be that investment decisions of these market players could have a greater impact on market liquidity conditions going forward*".

These factors all point to a state of ongoing illiquidity in the corporate bond markets, at least for a material sub-set of the asset class, even in benign periods. This will not change anytime soon, and requires careful consideration by regulators and market participants given the potential systemic risks involved. While standardisation and other solutions have been suggested, we

[7] Commenting on the Fair and Effective Markets Review at "Making Markets Fair and Effective for All", 20th January 2015.

believe they may have limited impact. We discuss these in more detail below, and are actively reviewing the feasibility of these and other potential improvements to market liquidity, which we would be happy to discuss further with the Review.

Standardisation of issuance:

The Review refers to standardisation as a potential solution for illiquidity in the corporate bond markets. We agree that standardisation would help, but as with all asset classes, standardisation must suit both parties for the market to be effective. The financing requirements of corporate bond issuers are the primary consideration when assessing the appropriate issuance profile for this market. The Review will no doubt be discussing this with various issuers and will understand their perspective – as issuers ourselves and from our client relationships, we know that funding needs will vary, that issuers benefit from having flexibility in entering the market for funding, and that they don't wish to be exposed to the risks associated with refinancing large debt issuances. In addition to the requirements of issuers, bespoke investor demand regarding bond profiles will also contribute to the heterogeneity of issued bonds.

While we believe that standardisation should be a matter of voluntary market evolution, the potential for greater standardisation should not be dismissed out of hand, as it could indeed help liquidity, at least to some degree. For example, the reopening of existing bond issuances (as opposed to the issuance of a separate new security) could improve levels of standardisation. However, a particular challenge here is the tax treatment of debt instruments issued as part of a bond reopening. Separate tax treatment of individual tranches of a reopened bond means that issuances may not be equivalent/fungible for tax purposes. While some permitted reopening exemptions may exist under existing tax rules, these are of limited use in the secondary markets. This could be an issue for further consideration by the Review.

All-to-all platforms and electronic trading:

We are supportive of all-to-all trading platforms, and we do not believe that any further regulatory changes are required to encourage the evolution of or participation in these platforms. There are numerous examples of such platforms being introduced in recent years.[8] However, we acknowledge that all-to-all trading platforms, in particular those operating on an anonymised basis, may have limited liquidity benefit for the corporate bond market. The market-making function undertaken by dealers cannot be performed in the same manner by buy-side participants, particularly in stressed markets, as they would be faced with significant conflict issues in performing a role (and absorbing risks) traditionally undertaken by sell-side participants (and would face the same capital and other constraints of sell-side participants if they markedly

[8] Examples include Bondbook, Bloomberg BOOM, NYSE Bonds.

changed their structures or strategies). As regards the 'shadow banking' sector more broadly, we do not believe this would fill a significant liquidity gap in times of market stress.

Moreover, while electronic trading is often discussed as a basis for achieving greater market liquidity, we consider increased electronic trading to be a natural evolution for markets that experience increased liquidity – securities and other assets will trade electronically *because* they are liquid, they will not become liquid by virtue of increased electronic trading opportunities. Looking at the FX markets, increased liquidity of the more simple FX products has led to widespread use of electronic trading platforms. Current corporate bond market liquidity issues will not be solved by electronic trading or greater market transparency – improved roads are undoubtedly a good thing, but it is the absence of sufficient parking space that is causing the problem.

C. The role of transparency in the fairness and effectiveness of markets

The Review discusses transparency as a characteristic of the fairness of FICC markets. We believe that transparency should be discussed as a wider theme when assessing both the fairness *and* effectiveness of markets. We consider there to be three key aspects of transparency when looking at financial markets: (1) transparency to regulators; (2) price transparency; and (3) transparency (fair disclosure) of risk and of dealings. The right level and quality of transparency contributes directly to the fairness *and* effectiveness of markets, but that is not to say that in each case greater transparency improves fairness and effectiveness, an issue that the Review has carefully considered in its definition of transparency.

1. Transparency to regulators

As regards transparency to regulators, we are fully supportive of existing and planned regulatory reforms (notably the derivative transparency requirements under the European Markets Infrastructure Regulation, and the securities financing transaction transparency requirements under the draft Securities Financing Transaction Regulation) and believe these should provide regulators with the tools to monitor market behaviour effectively. We encourage regulators to continue to work together to ensure consistency of regulatory requirements, where appropriate, so that market participants can achieve reasonable efficiencies in meeting substantively equivalent reporting requirements in multiple jurisdictions.

2. Price transparency

As regards market transparency, understandably the Review does not wish to re-open the debate on the calibration of MiFID 2 pre and post-trade transparency. The arguments for appropriate tailoring of transparency rules are familiar to the Review, and have come from both sell and buy-side market participants concerned about the liquidity impact of market disclosure requirements for large and/or illiquid positions. Without this flexibility, there is a real risk of damage to the liquidity and effectiveness of some markets. We believe that reasonable dissemination delays for block size trades are measures that promote more effective markets by balancing the goals of transparency and liquidity for large size trades. As mentioned previously, professional market participants should be able to make a risk/reward decision on an informed basis regarding market transparency, in order to benefit from greater market liquidity. The importance of the calibration of transparency rules is recognised by the CGFS, commenting that "*policymakers will need to balance the trade-off between promoting market transparency by disclosing dealer data and sustaining the willingness of market-makers to take on large positions in less liquid markets where inventory can only be run down over an extended period of time. Disseminating lagged and sufficiently aggregated data provides one option to achieving such a balance*".[9] In the U.S. corporate bond markets, which currently do not benefit from block trade dissemination delays, we believe the market faces significant ongoing liquidity challenges for large positions. With the investment and liquidity needs of end users in mind, a sensible outcome to the MiFID 2 debate is crucial.

3. Transparency of risk and transparency of dealings

While market transparency impacts both the fairness and effectiveness of markets, risk-related transparency and transparency of dealings are equally important to the question of fairness. We do not wish to over-emphasise application of the principle of caveat emptor, or to suggest everyone for themselves/anything goes. However, we believe that a fair and effective market is one where professional market participants can protect their own interests adequately. Fair disclosure and fair allocation of risk play crucial roles, and again, calibration of regulation can play a key part in this.[10]

Regulatory requirements as to disclosure of risks (and the application of those requirements) should have the effect of enabling professional market participants to understand and quantify risks, and accept/manage them accordingly. Professional market participants should ensure that

[9] http://www.bis.org/publ/cgfs52.pdf - section 6.1, p.36

[10] As regards allocation of risk and the inter-play with risk transparency, we would raise the example of Article 101 of the Level 2 implementing Regulation for the Alternative Investment Fund Managers Directive – this has the effect of placing quasi-strict liability on depositaries for loss of assets, including where the depositary has not acted negligently, meaning the depositary insures the fund for a risk which could rightfully (subject to adequate transparency of the risk) be borne by the fund. It is debatable as to whether the current calibration of this regulation achieves fairness and effectiveness in the market.

they apply sufficient time and resources to understanding the risks disclosed to them, and risk disclosures should be clear and concise in their description of key relevant risks. It is not always the case that more detailed risk disclosure (standardised or otherwise) contributes to a better understanding of key risks – careful consideration and articulation of key risks is most important.[11]

Appropriate transparency of dealings between market participants contributes significantly to achieving fair and effective markets. While this is an obvious point to make, the challenge is ensuring that market participants follow core regulatory requirements, codes of market practice, and otherwise act with integrity in providing transparency in how they deal with clients, but are not unduly constrained in how they handle their risk management and market-making activities. It also means that participants understand the risks they each bear, and have certainty on how they can manage those risks on an absolute basis and relative to one another. Thus, as in any other market, we believe the certainty of dealing in FICC markets is a critical component of allowing professional market participants to negotiate the correct allocation of risks and rewards.

The Review raises concerns around conflicts management, internalisation, use of confidential information and other issues where we believe transparency of dealings is crucial in ensuring fairness and effectiveness of markets. We have recently provided a global letter to our Institutional Fixed Income Clients, providing transparency on various aspects of our trading relationship with clients, and it is an example of how we have approached transparency of dealings in areas not necessarily codified by regulation. We would be happy to share a copy of this with the Review.

D. Fairness and other conduct-related issues

1. Conflicts management

As with most financial and other markets, potential and actual conflicts of interest exist in the FICC markets. The types of conflict will obviously vary, depending on the market and on the relevant market participants, and can evolve over time. The Review has asked for views on whether radical action is needed to remove conflicts altogether. Given the complexity of organisations and markets, we believe that the focus should be on effective conflicts management, and the achievable goal is for regulators and participants to identify and manage conflicts effectively across the market.

[11] With the introduction of new regulations there is obviously a desire by firms to ensure compliance with rules, often with little precedent to draw on in terms of the correct interpretation of those rules. While standardised risk disclosures are helpful, in some cases a good understanding of core fundamental risks may be lost as a result of overly-detailed disclosures. Morgan Stanley's approach to such disclosures has been to focus on clarity and simplicity, rather than adopting over-detailed standardised disclosures, and we attach a link to an example disclosure: http://www.morganstanley.com/institutional/sales/EMIR_Risk_Dislosure_Final_2.pdf?v=09232014

We believe that some of the key features of effective conflicts management have been summarised well in Box 6 of the Review. There are of course other conflicts which are less directly related to information flow, but which may nevertheless impact the fairness and effectiveness of markets (we would refer the Review to FINRA's October 2013 Report on Conflicts of Interest, Appendix III of which provides a useful summary of key conflicts identified by FINRA as part of its review work[12] - FINRA's industry-wide review of conflicts provided helpful observations and guidance to the market, recognising that a standardised approach will not always work for conflicts management, and that prescriptive rules were unlikely to be an appropriate tool for managing inherent conflicts).

We believe clarity within regulation and market codes as to the *core features* of effective conflicts management frameworks is key, while avoiding rules or standards which are too prescriptive, given the variety of market participants and the conflicts which may arise. As part of their supervisory function, regulators can make ongoing assessments of the effectiveness of these frameworks and require firms to make necessary adjustments accordingly, while continuing to work with market participants and relevant associations on updating codes/market practice standards.

We would be happy to share with the Review information regarding Morgan Stanley's conflicts management framework.

2. Market standards

Market-led practice standards and codes of conduct are an essential foundation for the fairness and effectiveness of the FICC markets, and play a crucial role in supplementing the regulatory framework, and providing clarity as to the expectations of the market and its participants. We recognise that there is an ongoing challenge here, in terms of ensuring that these standards always constitute an effective articulation of industry best practice, are consistent with core regulatory standards, and are fully understood and followed by individuals operating in the markets. There must be an effective process behind the development and maintenance of these standards, which should be consistent with regulation and provide sufficient guidance so as to support the fairness and effectiveness of markets. We believe this can be the case, notwithstanding the standards being led by market practitioners and their representative associations.

Below are some key comments we would make in that regard. These suggestions are not a statement as to the inadequacy of existing standards, many of which are effective benchmarks for market practice. Instead, they are intended to suggest an objective framework within which existing standards can reside, and within which future standards can be developed:

[12] http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf

- We believe that any work undertaken to coordinate and develop FICC market standards should be undertaken by one or more international standards setting bodies. Representation should include regulators and a range of industry participants and/or their representative associations.
- Having made an assessment of the global and regional FICC markets, and of the types of market participants who are active and the asset classes traded in those markets, those standards setting bodies should make a determination of the most logical framework for market standards (i.e. which markets require separate standards, whether international, regional or jurisdiction-specific standards are most appropriate, and which industry associations are the most appropriate to issue such standards) taking into account the views of regulators, a broad range of market participants and other stakeholders. The outcome of that work should not give rise to a 'top down' prescriptive development of market standards; rather, it should serve to identify an end goal, and to inform the basis for modifying and enhancing existing standards.
- Having determined the relevant framework, a determination should also be made of the 'key features' of a suitable set of market standards. This is not a question of what the standards themselves should be; rather, it is a question of which key features of a standards-setting process will contribute effectively to the existence of appropriate standards. While this may well vary between markets, examples may include: the range of participants involved in developing the standards (not necessarily just the members of the association issuing the standards, although the fact of the issuing association having a limited range of members should not prevent standards being viewed as effective); the forum for developing the standards and the regularity with which the standards are tested/adjusted; the structure and clarity of standards; and associations who issue standards should have a process for addressing issues raised by members or market participants.
- Standards should be drafted in simple, clear language, with a suitable range of scenario-specific examples of good and bad practice. The successful adoption and market-wide understanding of these standards will depend on this – in that regard, simplicity of language used is key.
- To some degree, standards should 'speak to each other', in that ongoing assessments should be made of the commonalities of standards and underlying issues across FICC markets, so that, where appropriate, consistent best practice approaches are adopted and consistent language used.
- The international coordinating body(ies) overseeing these standards should endorse them where they regard them as appropriate.

* * *

Morgan Stanley has been an active participant in various expert groups and market practitioner panels contributing to the Review. We look forward to assisting the Review in its ongoing work.

Yours faithfully,

Colm Kelleher
Managing Director
President, Institutional Securities