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Fair and Effective Markets Review

Dear Sirs

We are pleased to enclose our response to the review.

Schroders manages £276 billion on behalf of institutional and retail investors, financial institutions and high net worth clients from around the world, invested in a broad range of asset classes across equities, fixed income, multi-asset and alternatives. We are grateful for the opportunity to comment on the Fair and Effective Markers consultation document.

We fully agree that given the recent misconduct (and not withstanding the regulatory changes already in train or being negotiated at an EU level) a stock take of the structure around the FICC markets is useful. Overall we believe that there has already been a reappraisal of the risks in the market and a number of useful regulatory changes are in the process of being implemented. We would, in particular highlight our concerns about the innate illiquidity of bond markets and the importance of maintaining and enhancing such liquidity.

We would be happy to discuss our responses with you further should you so wish.

Yours faithfully

Sheila A. Nicoll

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Section 4: 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?**

   The definition appears to strike the right balance between safeguarding participants' interests and not impeding the FICC markets 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?**

   We suggest the most important factor contributing to the recent market abuses has been the breakdown of appropriate market conduct by individuals. This conduct has been exacerbated by weaknesses in the design and governance of market structures. For example, the manipulation of LIBOR and FX benchmark fixes were primarily a result of a failure in market conduct through collusion but the way these benchmark rates were calculated meant they were more open to abuse.

Section 5. Specific issues in FICC markets

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?**

   These options would appear to increase the incentive to misbehave and so pose increased risks. We believe that consideration should be given to additional rules on the disclosure of significant option positions.

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?**

   The combination of new capital requirements, bank structural reform and firm's own internal risk management appraisals, has resulted in banks becoming less willing to hold

inventory. This, together with the low interest rate environment encouraging an increase in new issues means overall liquidity in fixed income has been reduced thereby diminishing the effectiveness of the market in smoothing out price volatility.
The 'in-train' regulatory changes which will affect the operation of the fixed income market as a consequence of MIFID II are unlikely to assist in improving this situation and have the potential to exacerbate it. Schroders supports the MiFID2 proposals to extend pre and post trade transparency regimes to European non-equity markets. The transparency regime needs, however, to be very carefully calibrated in order not to inhibit or reduce liquidity provision in corporate bond markets.

As the consultation paper points out, the majority of corporate bond trades are traded with market makers who act as principal rather than agent, so we are keen to ensure any transparency regime does not inhibit market makers' willingness to make markets and take positions. For example many older and smaller corporate bond issues trade infrequently, many on average once a month. A market maker may be less willing to take on a large position in such a bond if the trade is subject to immediate post trade publication. In current markets market makers may take weeks to work out of such positions and immediate post trade transparency may reduce their willingness to take on larger positions. A sensitive implementation of the requirements surrounding pre and post-trade transparency is needed in order not to worsen current liquidity issues.

In terms of other jurisdictions, in the much bigger and more liquid US corporate bond market, SEC rules place an obligation on broker/dealers to report transactions in corporate bonds using the Trade Reporting and Compliance Engine (TRACE). We believe his has resulted in tighter bid-offer spreads but with some reduction in liquidity.

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?

We are concerned about the innate illiquidity of bond markets. Every change considered should reflect the need to improve liquidity.

We are in favour of greater use of electronic trading venues, and would agree with the diagram on page 27 of the consultation paper which details the likely shift to more electronic trading in future for various classes of instrument particularly high yield and investment grade bonds. We believe IRS will see significant moves to greater electronic trading as European market participants' move to clear swaps and increasingly make use of standardised swaps such as the MAC (Market Agreed Coupon) swaps.

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

We would agree that improved secondary market liquidity could result if the overall number of new issues of fixed income securities was reduced. We believe some limited standardisation of issuance would therefore help as some rationalisation is required, but we believe substantial standardisation is neither desirable nor achievable. It is beneficial for asset managers and corporate treasurers to have a range of issues both across the curve and capital structure. This enables investors to find and invest in structures that best suit their investment criteria and enables treasurers to finance their activities in the most efficient and competitive manner. Corporate treasurers prefer funding their

businesses with an appropriate number of issues so as to avoid re-financing risks that having a smaller number of issues may bring.

The lack of significant movement in this area by the market itself (i.e. without regulatory intervention) suggests current incentives do not support this. Issuers are acting rationally by accessing better terms under the current regime (and many are taking advantage of the current low interest rate environment). And those investors who seek a competitive advantage by analysing the differences between different bonds offered are similarly acting rationally and see the advantages of the current market structure.

Differences in tax and insolvency law between Member States would be one way to reduce the incentives to over-issue. Whilst we appreciate the difficulties surrounding harmonisation of tax at an EU level, changes to insolvency law, or at least the recognition of the law under which a contract has been made, should be a key part of the wider capital market union policy work currently under way in the EU which is seeking to encourage growth via non-bank finance.

A single credit database would improve availability of information, and enhance liquidity.

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?

We agree that the transparency of the new issue process needs to be reconsidered. The consultation paper sets out the advantages and disadvantages of the current system. Rather than a major change to the new issue process by moving to an auction process, we consider a more appropriate regulatory response would be greater post-trade transparency of the new issue process. Transparency should not be limited to publication of final allocations but should also detail geographical allocation and type of institution (Bank, insurer, asset manager). Such a move would highlight perceived favouritism and should result in a better new issue process.

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?

Foreign exchange markets are characterised by dominant positions of a few very large bank participants. It is observable that they continue to make out-size profits from their position.

There is a clear lack of transparency with regard to internalisation. but we are unable to draw any firm conclusions with regard to the internalisation of FX flow and would welcome a study to determine any market impact that this practice imposes. In normal market conditions there are clear benefits to internalisation as we can achieve bid/offer spreads that are narrower than those available in the external market, however we do have concerns that in times of stress the ability to internalise flow can be less effective when market flows are the same way. There has been an increase in market events where these concerns have become more real.

The practice of last look has created more of an issue with regard to wider market liquidity. It seems to us that the increase in High Frequency Trading companies and

secondary electronic communication networks (ECNs) has exacerbated the issues around last look. We also have some concerns that there has become more dependency on the secondary ECNs to provide liquidity to the FX markets but in times of higher volatility some of these names pull away from the market and false liquidity is exposed and markets gap wider. We would welcome a more in depth review of the number of ECNs providing liquidity in the FX market to give the market more transparency as to who adopts the last look practice.

We would welcome a more effective structure around pre and post trade transparency for FX markets. There are a growing number of Trade Cost Analysis companies who carry out this analysis, although there are no consistent sources of data. There are more enquiries from end investors concerning post trades market analytics. One of the major barriers here centres on the amount of false liquidity within the market and the worsening of market liquidity. It can be hard to carry out effective pre/post trade analysis in an OTC market where, depending on the source, prices can differ and are not consistent.

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

We welcome the recommendations made by the FSB with regard to improving the structure concerning Foreign Exchange benchmarks. A more comprehensive netting and execution facility for transacting foreign exchange transactions could work via an auction process with residual flow potentially being executed via algorithmic trading strategies. This would improve transparency and reduce conflicts of interest.

The barriers that could potentially impede this change in structure mainly centre around implementation and market structure. In our opinion regulatory changes would need to be imposed for this to work.

Commodities

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

When investing in commodities we have primarily been users of US markets and looking to the future, we see any significant development is more likely to occur in Asia, not Europe. So we suggest that changes to market practices to improve transparency generally should be undertaken on a global level and not be EU or UK focussed only.

Our experience of trading OTC is limited. In the past we traded OTC with the introduction of stricter position limits in the US market, and the use of OTC allowed us to get appropriate market exposure. The benefit of OTC is the flexibility to trade outside of exchange hours, but they will naturally be less transparent. That said, transparency will be improved by the introduction of the MIFID II regime.

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?

In terms of fixed interest markets we believe that improvements to insolvency law would address some of the structural problems faced. In particular the recognition of the law under which the contract is made by EU governments would assist.

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?

We are supportive of the recent changes to benchmark regulation in the UK, specifically the new legislation to regulate LIBOR and the proposed extension of this regime to other benchmarks. In addition we note the EU proposal to regulate benchmarks and whilst we do not necessarily agree with the scope of the Directive as it relates to users of benchmarks, we suggest that the proposals are far reaching and no additional proposals should be made until those already proposed have been implemented and their impact duly considered.

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

We use benchmarks to measure our performance and this is primarily a result of client wishes. As such we do not contribute data on the calculation of the benchmarks produced and so cannot manipulate them. We do not believe that the answer to problems in the quality and construction of benchmarks is to seek to reduce their use.

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

See our response to question 21.

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

We do not have strong views on this point

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

See our response to question 21.

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

See our response to question 21. 3rd country jurisdictions are covered in the EU benchmark proposal.

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?

We believe that (b) is the case – firms should be reminded of existing standards by regulators and within firms, such standards need to be clearly communicated and

understood by relevant staff. Existing standards, if followed and properly enforced would seem to be the most appropriate regulatory response.

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?**

    No comment

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?**

    See 27. Above, we support (a) better education regarding existing standards.

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

    See question 29 response above.

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?**

    We are supportive of qualifications and the use of continuing professional development schemes

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

    Codes, in themselves, are not sufficient if they are not properly monitored and enforced. We believe that it is important not only to educate market participants, but also to be clear that there will be consequences of not complying.

33. **How would any code tackle the design issues discussed in Section 5.4.3, i.e.: 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?**

    There is a tension between having a code which is sufficiently high level to allow for innovation, but sufficiently detailed for market participants to understand what is expected of them, but this is not a new issue. There clearly needs to be a review process to ensure that codes are kept up to date and the ability of a regulator or standard setting body to enforce against it would help give it teeth.

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.' These are equivalent to FCA Principles 7 (Integrity) and 2 (Skill, care and diligence) and 7 (Communications with clients) suggesting these principles should be applied to business between eligible counterparties.

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 consider that the scope of regulation for financial instruments should mirror the requirements of EU law.

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?

We would agree that poor incentive arrangements, inadequate governance and accountability played a major role in recent market abuses. There have been a number of changes to incentive arrangements both domestically and through EU rules changes, for example through increasing deferral and claw back arrangements. We would suggest these new rules need to bed down before further regulatory changes are considered.

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?

Yes. It is too early to tell which amendments have worked best but the remuneration changes have changed incentives away from short-term behaviour.

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?

No comment.

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 suggest existing measures need to be implemented, operated and then reviewed before extending regulation further.

Surveillance and incentives

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?

Recent cases of wrongdoing in FICC markets have highlighted the lack of supervision and surveillance of FICC markets in the belief that they would be self-policing and only accessible by knowledgeable and professional people. The reaction to recent and ongoing enforcement action has already meant a step up in terms of a reappraisal of risk management arrangements by firms and new legislation is in the process of being introduced. Proposing further regulatory intervention at this point should be carefully considered in the light of the cost and effectiveness of current and proposed changes.

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?

No comment

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)?

We believe that firms' remuneration structures processes need to take account of adherence to appropriate cultures, with attention being paid to risk, legal and compliance issues. There should be clear senior management oversight of these processes. We believe that deferred remuneration awards should be capable of being reduced or clawed back in the event of malpractice.

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?

Where we are asking our counterparty to act as principal and they are the only holder of the asset you wish to purchase, for example a corporate bond, it is difficult to move business away from that counterparty as a 'punishment'. So market positioning and flow can sometimes dictate who we engage with. That said we follow and ensure we are aware of any proven malpractice and specifically who did what and take this into consideration in our internal processes.

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

As we state in our response to question 40, the belief that FICC markets were self-policing was misplaced. So we would expect a reappraisal of the risks associated with the FICC markets to take place and have already seen greater supervisory intensity as a result of measures already taken. We would support such a risk based approach to supervision of the FICC markets.

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?

We would suggest regulators look at the issue of data requirements once they have considered the adequacy of data received as a result of MIFID II implementation.

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

No comment

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?

No comment

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

No comment

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?

No comment