MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

30 January 2015

Via Electronic Submission

Fair and Effective Markets Review
c/o Bank of England
Threadneedle Street
London, EC2R 8AH

Re: Fair and Effective Markets Review: Consultation document, October 2014: How fair and effective are the fixed income, foreign exchange and commodities markets?

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to provide comments on a consultation document, "How Fair and Effective are the Fixed Income, Foreign Exchange and Commodities Markets?" (the "**Consultation**")[2] published by the UK Fair and Effective Markets Review ("**FEMR**") on 27 October 2014.

MFA strongly supports the efforts of FEMR to improve the fairness of the Fixed Income, Currency and Commodities ("**FICC**") markets and to seek the views of stakeholders on ways in which, where necessary, fairness and effectiveness of FICC markets might be improved.

MFA concurs with FEMR's view that the global FICC markets underpin almost every major financial transaction in the global economy. They help determine the borrowing costs of households, companies and governments, set countries' exchange rates, influence the cost of food and raw materials, and enable companies to manage financial risks associated with investment, production and trade. They are vast in size, and support employment for many around the world, not least in the United Kingdom, where a substantial share of these markets is based.

Our responses focus primarily on cleared OTC derivatives trading given: (1) the upcoming MiFIR trading obligation, (2) our members' experience with trading cleared OTC derivatives on registered swap execution facilities ("**SEFs**") in the U.S., and (3) our concerns with achieving "impartial access" to SEFs under the regulatory regime of the U.S. Commodity Futures Trading Commission ("**CFTC**") and anticipated similar challenges with respect to

[1] MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals, and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] Available at http://www.bankofengland.co.uk/markets/Documents/femr/consultation271014.pdf

achieving "non-discriminatory access" to organised trading facilities ("**OTFs**") in the EU. While the examples we provide are specific to the cleared OTC derivatives markets, in our view, many of the same concerns with respect to open, impartial, and/or non-discriminatory access exist across a broader spectrum of FICC instruments, including many segments of the bond markets. We would also similarly encourage FEMR to consider issues of open access in relation to the market infrastructure supporting FICC markets. While buy-side access to central clearing for OTC derivatives will be achieved through EMIR, for example, there is presently no buy-side access to central clearing services for repurchase agreements, or repos.

MFA offers the following responses to the Consultation:

Q1: 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?

MFA strongly agrees with FEMR's proposal to incorporate the issue of market access into the definition of "fair and effective" FICC markets. In particular, MFA agrees with FEMR's statement on page 17 of the Consultation that:

> *there should be open access to FICC markets for all, either directly or through an open, competitive and well-regulated system of intermediation. This criterion implies that access to a market should be on terms that are reasonable and transparent, do not confer unfair advantage on large or otherwise incumbent firms, and allow at a minimum effective intermediated access for all.*

However, as described further in our response to Q4 of the Consultation, we believe that FEMR should go further and put in place specific regulatory requirements intended to break down and prohibit the "two-tier" system of trading venues currently operating in the FICC markets, as explained below. This two-tier system should be replaced with a non-discriminatory system of open access to trading venues which will necessarily assist in achieving FEMR's laudable goal of open access to FICC markets for all.

Specific consideration of the open access issue is vital ahead of implementation of the trading obligation under the MiFID Regulation[3], which will necessitate many more market participants being required to trade in the FICC markets on trading venues than is currently the case. In particular, it is crucial to consider whether all market participants subject to the trading obligation are able to gain access to the full range of trading venues available in the FICC markets, not only in order to satisfy their regulatory obligations under the MiFID II trading obligation, but, equally importantly so far as fairness and effectiveness are concerned, in order to gain access to the most beneficial pricing and liquidity possible in the FICC markets.

As noted, many FICC markets currently operate a "two-tier" system, whereby smaller and exclusive groups of dealers trade with one another on interdealer venues, with other types of

[3] Regulation (EU) No 600/2014 of The European Parliament and of the Council of 15 May 2014 on markets in financial instruments, available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32014R0600

market participants, including many of our members and other buy-side market participants, only able to trade with that group of dealers either bilaterally or on a limited and inadequate number of dealer-to-customer venues. In our view, excluding market participants which should otherwise be eligible to trade on interdealer venues through certain means which are described below in our response to Q4, offends against the principle of open, competitive and fair market access as expressed by FEMR in the Consultation. Instead, MFA strongly believes that such access should facilitate the emergence of "all-to-all" markets that would replace this two-tier system. The regulatory promotion of such "all-to-all" markets is particularly warranted given (for example) new requirements for the clearing of OTC derivatives, which greatly reduce or extinguish counterparty credit risk when reinforced by the straight-through-processing requirements contained in MiFID II.

In light of the upcoming implementation of the MiFID II trading obligation, and the increasing focus by regulators on market efficiency and competition in the financial services sector, MFA strongly recommends that FEMR takes action now to rectify the significant asymmetries which currently exist in relation to accessing the trading venues used in the FICC markets.

Q4: 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?

Current market microstructure: the two-tier system

In our view, the current two-tier system of interdealer and dealer-to-customer markets described in our response to Q1 significantly diminishes fairness and effectiveness in the FICC markets. Such a system has a number of negative effects; for example, it limits competition among dealers and acts as a barrier to entry for alternative liquidity providers. Increasing access to interdealer markets and creating a genuine system of "all-to-all" markets would, on the other hand, provide numerous benefits to the FICC markets, for example, increasing liquidity; more competition, ultimately resulting in narrower spreads; and enhanced price discovery. These benefits represent a positive outcome for the FICC markets and in particular for buy-side market participants, whose ability to conduct hedging and risk management activities, along with the benefit of reduced costs for such activities, would improve as a consequence of enhanced price transparency and liquidity levels.

In addition, the current two-tier system perpetuates the concentration of risk in a relatively limited number of incumbent dealers in the FICC markets. We note in this respect the concern expressed by FEMR that since the financial crisis, it has become more difficult for buy-side firms to step back from trading with specific sell-side counterparties, or to exert market discipline due to increased market concentration in the sell-side sector. Addressing open access would be an important way in which FEMR could start to address this issue, and would also be helpful generally to markets in reducing the systemic risk posed by too-big-to-fail sell-side dealers. Allowing the current two-tier system to continue, on the other hand, will simply serve to perpetuate the trading and information advantages of those dealers that have access to both interdealer markets and dealer-to-customer markets.

Finally, there is clear evidence that having a two-tier market structure in place limits investor choice. For example, in the U.S., dealer-to-customer SEFs only offer fairly homogenous

request-for-quote trading systems, whereas interdealer platforms offer a much wider variety of trading systems, including central limit order books. This imbalanced market structure presents a significant issue for investor choice given that, while many buy-side market participants would prefer to have the option to trade anonymously through an order-driven system, buy-side participants are effectively confined to trading on dealer-to-client, quote-driven markets for certain derivatives transactions that are currently required to be traded on SEFs. FEMR should take steps to prevent a similar divergence developing in the market for OTFs ahead of the introduction of the MiFID II trading obligation.

In-train regulatory changes

The introduction of the MiFID II regime is positive in that it mandates non-discriminatory access by trading venues (see, for example, Article 18(3) of the MiFID II Directive[4] governing MTFs and OTFs, and Article 53(1) of the MiFID Directive governing regulated markets, both of which require trading venues to establish "transparent and non-discriminatory rules, based on objective criteria"). Thus, any trading venue rules which either explicitly or implicitly prevent a whole category of market participants, which would otherwise be eligible to trade, from accessing the venue do not meet this standard of being "objective" or providing "non-discriminatory access".

In addition, pursuant to Article 18(4) of the MiFID II Directive, MTF and OTF operators are required to have in place arrangements to identify and manage the potential adverse consequences for the operation of the MTF or OTF, or for its members or participants and users, of any conflicts of interest between the interests of the MTF, the OTF, their owners or operators, and the sound functioning of the MTF or OTF. Structuring an MTF or OTF so as to limit trading on that venue to a small group of dealers when there are participants in the market that would otherwise qualify for membership seems to us to create a significant conflict of interest between the operator and the functioning of the MTF or OTF itself, which might otherwise benefit from higher liquidity levels given a greater number of members.

However, although the MiFID II framework is helpful in forming a "baseline" for compliance, MFA would urge FEMR to take steps to ensure that the MiFID II "non-discrimination" standard set out in Articles 18(3) and 53(1) of the MiFID II Directive is properly applied in practice. There are precedents under both the EU equities regime[5] and under the U.S. Dodd-Frank regime (see below) to suggest that allowing markets organically to move towards this non-discrimination standard at their own pace is ineffective.

Indeed, the ECMI-CEPS task force charged with reviewing the implementation of MiFID concluded in 2011 that:

> *more remains to be done, however, to solve existent commercial and technical challenges in terms of access, interoperability and unbundling…In effect, while the original MiFID Directive (Article 34) envisaged a level playing field in terms of non-*

[4] Directive 2014/65/EU of The European Parliament and of the Council of 15 May 2014 on markets in financial instruments, available at http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32014L0065

[5] See for example, page 58 of MiFID 2.0 "Casting New Light on Europe's Capital Markets" (ECMI-CEPS Task Force), which describes the Committee of European Securities Regulators' conclusion that the provision of order information to certain market participants only, on a discriminatory basis, was "unfair" and a violation of MiFID principles.

> *discriminatory access to competing infrastructures, the transposition of this provision into national law and its enforcement has been inconsistent across EU member states. As such, greater efforts need to be made to ensure consistency in the enforcement of the regulatory framework*[6].

Given, therefore, that the non-discrimination standard applying to regulated markets and MTFs has to date been implemented with very limited success, FEMR should not expect implementation of the non-discrimination standard to run smoothly in the case of OTFs. Instead, additional regulatory measures are required so as to ensure that UK trading venues adhere to requisite standards of MiFID II in relation to access requirements.

How do these answers vary across jurisdictions?

The U.S. experience in implementing the Dodd-Frank trading obligation and the "impartial access" requirement set out in Section 733 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**")[7] and CFTC Regulation 37.202[8] may be instructive in illustrating the difficulties that U.S. regulators have faced in enforcing the requirement for "impartial access" to trading platforms (the U.S. equivalent of the MiFID non-discrimination standard). Similarly, certain guidance issued by the CFTC could inform FEMR on how to move forward with drafting more detailed standards in this area[9], although the CFTC has not yet gone far enough in enforcing the impartial access standard given that, contrary to the stated aim of the CFTC, a two-tier system of interdealer and dealer-to-customer markets still remains in place in the U.S.

Certain provisions in SEF rulebooks which our members have previously encountered and which may be instructive in relation to the types of practice which SEFs have previously engaged in and which offend against the principle of impartial access, and should therefore be prohibited in rulebooks of EU trading venues, are as follows:

(a) Certain SEFs have in the past required SEF participants to represent that they are self-clearing (*i.e.,* that they are the equivalent of a direct clearing member of an EU CCP). Only a dealer participant would be able to make such a representation, given that while certain dealers are self-clearing, virtually no buy-side firms are in such a position. Therefore, this unnecessary requirement has effectively been used to exclude buy-side participants from gaining access to many SEF platforms.

(b) Certain SEFs have imposed "enablement mechanisms" (*i.e.,* mechanisms, counterparty filters, or other arrangements preventing a participant in a SEF from

---

[6] See page 162 of "MiFID 2.0: Casting New Light on Europe's Capital Markets".

[7] Pub. L. 111-203, 124 Stat. 1376 (2010). Section 733 of the Dodd-Frank Act requires, in pertinent part, that SEFs establish and enforce participation rules and have the capacity to enforce those rules, including means to provide market participants with impartial access to the market.

[8] See CFTC Regulation 37.202 in the CFTC Final Rule on "Core Principles and Other Requirements for Swap Execution Facilities", 78 Fed. Reg. 33476 (June 4, 2013), at page 33587.

[9] See, for example, "Division of Clearing and Risk, Division of Market Oversight and Division of Swap Dealer and Intermediary Oversight Guidance on Application of Certain Commission Regulations to Swap Execution Facilities", issued by the CFTC on 4 November 2013.

interacting or trading with, or viewing the bids and offers (firm or indicative) displayed by any other participant in the SEF). In an environment where products are cleared, these mechanisms to enable/disable counterparties or to prevent counterparties from seeing streamed prices are wholly unnecessary.

(c) Certain SEFs have indirectly provided barriers to accessing the SEF *via* an agent or intermediary simply by failing to provide for the ability to do so in their rulebooks.

In addition to such explicit barriers found in SEFs' rulebooks, SEFs may also put in place implicit barriers designed to exclude buy-side market participants from interdealer platforms. For example, certain SEFs may put in place fee or pricing structures that are only affordable to larger dealers, while others may disclose counterparty identities following the execution of transactions ("post-trade name give-up"), which effectively imposes an implicit barrier to access by buy-side entities.

To conclude, the implementation timeline for MiFID II provides FEMR with the opportunity to identify and address similar issues in the UK market prior to implementation of the trading obligation. MFA would be happy to be a source of further information on this issue if necessary.

Q19: Are there any additional regulatory reforms that could be helpful in promoting competition and market discipline in FICC markets?

Please see our above comments on open access. Open access, of the nature described above, is vital to ensuring that market participants are able to compete on a level playing field and thereby to promote fair competition in FICC markets.

Q32: What role can market codes of practice play in establishing, or reinforcing existing, standards of acceptable market conduct across international FICC markets?

MFA would strongly prefer to see the open access issue dealt with *via* specific regulatory or legislative measures rather than market codes. This preference is based upon the experience of our members in relation to the implementation of the Dodd-Frank trading obligation and the "impartial access" requirement, as summarised above.

In particular, it is vital that trading venues become subject to enforceable legislative or regulatory measures on the open access issue, given that they will not otherwise be incentivised to alter the current two-tier market structure. At present, interdealer venues run the risk that if they attempt to individually broaden access without a mandatory framework in place, incumbent dealers will exit the venue, taking their business to other venues that do not embrace principles of open access to facilitate buy-side participation.

* *

MFA thanks FEMR for the opportunity to provide comments on the Consultation. We would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Laura Harper Powell or the undersigned at +1 (202) 730-2600 with any questions FEMR or its staff might have regarding this letter or the Consultation.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director & General Counsel