# ISDA response to the Fair and Effective Markets Review Consultation
# 30 January 2015

## Executive Summary

We are grateful for the opportunity to respond to the Fair and Effective Markets Review (FEMR) consultation and for the Review's engagement with industry throughout the consultation period. We would welcome continuation of this open dialogue with industry as responses to the consultation are considered and recommendations are developed.

The goal of the review, as cited by the Bank of England is "restoring faith" in the fixed income, foreign exchange and commodities (FICC) markets. This is consistent with the International Swaps and Derivatives Association's (ISDA) own mission of ensuring safe and efficient markets.

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 67 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA would like to emphasise the following themes in its response to the consultation.

**1. New rules should be considered after assessment of the impact of current regulatory reforms**

The combination of - and balance between - fairness and effectiveness in derivatives business has been a key theme of regulatory deliberations since the start of the financial crisis. It is a challenge to address this issue for wholesale, sophisticated markets, subject to wide differences in liquidity and price visibility. If we take the example of the Markets in Financial Instruments Directive (MiFID), there is a real challenge associated with optimal calibration of transparency requirements for contracts ranging from highly standardised, flow products to the more episodic and bespoke. In particular, inappropriate calibration could make market makers unwilling to take on risk from hedgers for fear that they will not be able to lay it off efficiently. On the contrary, optimal calibration could optimise transparency, providing it where and how it is appropriate, and allows the market to continue to operate efficiently, meetings its users' needs.

As such, we believe that the current regulatory reforms need to be completed, effectively implemented and cumulatively assessed before further measures are considered. We realise that the primary purpose of FEMR is to address perceived deficiencies in market structure and conduct, but we would like to highlight that many markets, especially in Europe, have been made, or are about to be made subject to new regulation. Any new measures should add value and not duplicate, and certainly should not conflict with these regulations.

**2. Taking into account structure, variety and global nature of FICC markets**

It is important that the structure, variety and global nature of the different FICC markets are taken into account for instance in terms of product and documentation standardisation, electronic trading, liquidity, and their role in bespoke risk hedging. FICC markets are not homogenous. Some of the remedies put forward in the FEMR consultation e.g. standardisation (of which ISDA has long been a champion) are (and have been) more appropriate to specific FICC markets then others. It is important to assess users' needs regarding these very diverse markets.

Ultimately, any regulatory initiatives affecting derivatives business resulting from the FEMR should ensure that derivatives business can continue to be effective in intermediating asset and risk transfer.

**3. Focusing on cross-border regulatory cooperation**

This issue is of particular importance for OTC derivatives, the most 'global' of financial instruments. Ill-considered cross-border regulation reduces price competition and market access and balkanises markets, making them less fair and effective. This has been borne out in the context of the US swap execution facility (SEF) rules where cross-border guidance from the Commodity Futures Trading Commission (CFTC) has resulted in fragmentation in important derivatives markets, with trading relationships increasingly segmented on geographical grounds.

**4. Considering codes of conduct**

If a gap in regulation is identified, market codes can help to establish guidance as to best practice. Where standards already exist, any additional layer can cause confusion and unnecessary complexity. ISDA does not consider that it would be appropriate to include undertakings to comply with a market code into contracts, as it could create market disruption, systemic risk and legal uncertainty.

We remain available to engage in the upcoming FEMR discussions and refer to the below answers for detailed reflections and recommendations for potential further industry and regulatory work and cooperation.

ISDA

## Answers to Questions

### What does 'Fair and Effective' mean for FICC markets?

**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?**

We broadly agree with the Review's definition of 'fair and effective.'

Specifically:

- We agree on the fundamental importance of integrity to underpin markets.

- We also agree that equilibrium is needed, ie end-users' interests should be protected and the effectiveness of the FICC markets ought to be ensured as well. We welcome FEMR's recognition of important changes that MiFID II introduces for conduct rules. Please see our remarks on Q 28 for more details.

- We consider that the Review has understated the importance of liquidity as an element of a fair and particularly effective market. It is crucial that markets are effective in intermediating asset and risk transfer (the latter being an important function of derivatives markets). For this and the following bullet point we would like to underline the importance of regulatory responses being calibrated appropriately to ensure that their impact on liquidity is not adverse.

- We fully support the Review's acknowledgment that the objective of achieving greater transparency of price information needs to be balanced against the need to ensure liquidity. Please also see Q 5 for detailed remarks on this point and detailed views on structural changes.

In respect of competition we would like to make several remarks:

- Merit based competition is an integral feature of a fair and effective market and effective competition depends on market participants being free to pursue their commercial interests. We agree that the focus should be on equality of opportunity rather than equality of outcome. Notwithstanding, we agree that market participants should not benefit from competitive advantages obtained by improper conduct.

- Whilst we support the principle of open-access we believe that open access should not necessarily be interpreted as the elimination of all barriers to entry that may exist in markets. Minimum participation requirements (for example but not limited to capital requirements and central counterparty (CCP) membership conditions) may contribute to the effectiveness and safety of markets.

- Recent regulatory reforms might have increased or created further barriers to entry. As FEMR recognises, regulation can prevent new entrants from entering the industry. We accept that participation requirements must be sufficiently robust to ensure safety and efficiency of markets. Nevertheless, policy makers should be mindful of the potential for reforms to create barriers to entry and should seek to ensure that regulatory regimes achieve their purpose without unduly hindering or discouraging new entrants.

It is therefore vital that in assessing the effectiveness and fairness of FICC markets, that FEMR considers the effect of additional regulation on minimum requirements for entry and ultimately the effect on competition and market access. In this regard, we would stress that the FICC markets are global and diverse in nature and they differ in terms of product and documentation standardisation, electronic trading and liquidity profiles. Accordingly, an assessment of the effectiveness and fairness of a particular market will necessarily involve an assessment of the specifics of that market.

## A framework for evaluating fairness and effectiveness

**Q2: 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 believe that the current regulatory reforms need to be completed and implemented before any further measures are considered, for instance and especially on transparency, access, competition and infrastructure.

In the meantime, in terms of other important areas of vulnerability, there should be a focus on current deficiencies in the area of cross-border regulatory co-operation. This issue is of particular importance in the context of OTC derivatives, the most 'global' of financial instruments, in particular, in the implementation of rules on trading, clearing, reporting and margining, there are numerous examples of inconsistencies in the regulatory approach of different jurisdictions. Such inconsistencies and divergences can subject market participants to duplicative and/or conflicting requirements and creates the potential for regulatory arbitrage. Furthermore, insufficient cross-border cooperation risks market distortion, fragmentation, a reduction in competition and higher costs for end-users seeking to hedge commercial risks, with negative consequences for investment and economic growth and ultimately end-users.

Please see our response to Q 11 for further detail on this.

We strongly support the aims of the Financial Stability Board (FSB) in this area, as set out in their letter of 15 September 2014 to the G20 leaders (To G20 Finance Ministers and Central Bank Governors; Financial Reforms – Completing the job and looking ahead http://www.financialstabilityboard.org/wp-content/uploads/r_1409211.pdf ), namely to have an approach "based on co-operation, peer review and outcomes-based approaches to resolving cross-border issues" and the need to build a system combining common international standards including deferral to each other's approaches where appropriate.

We also welcome the International Organization of Securities Commissions (IOSCO) report on cross-border regulation and in particular that IOSCO aims to promote cross-border regulatory tools such as national treatment, recognition (unilateral as well as mutual) and passporting.

## Barrier and digital options

**Q3: 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?**

Barrier or digital options are just examples of the wide variety of derivatives. High level rules remain appropriate to ensure flexibility of a regime to address new and developing products rather than multiplicity of specific rules aimed at specific products.

Whether trading around a barrier or digital option constitutes hedging or defending that option largely depends on the subjective intentions of the party engaging in that trading. Therefore, whilst, it should be clear to those engaging in trading whether they are hedging or seeking to move markets, other participants/regulators will not be able to determine its characterisation based on position data. Accordingly, we believe a reporting regime would be ineffective and market manipulation rules which focus on management and compliance oversight and incentives would be preferable. As the FEMR consultation paper suggests, there may be merit in a further study as to whether any additional measures would be appropriate.

There may be a case for extending anti-manipulation rules to a wider category of FICC transactions, not just to qualifying investments and instruments linked to markets with an organised market facility. However, in our view, it will be important to ensure that rules are high level and sufficiently flexible to deal with market specifics, especially given the heterogeneous nature of the FICC markets. In addition, any extension of scope of anti-manipulation rules should not involve extension of insider dealing rules to markets without a central issuer or other source of critical information. In many markets, market participants will have access to different information and they should be permitted to transact, notwithstanding the information asymmetry.

## Market microstructure

**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**?

We believe the characteristics of FICC markets (being OTC and principal based) are not in of themselves prejudicial to transparency or fairness towards customers.

As to derivatives we believe that benchmark interest rate, credit index and standard FX forwards and FX non-deliverable forwards (NDFs) are extremely transparent and liquid. Customers do not suffer from not knowing where these products trade and almost always

ISDA

put dealers in competition. Enhanced transparency requirements in the Markets in Financial Instruments Regulation (MiFIR) will further increase standards of transparency. It is true of course that less liquid products, including complex derivatives trade less frequently and price discovery is more difficult. However customers can still seek competitive prices if they chose to do so. Migrating standardised products to venues is mandated by MiFIR. This will further encourage competition between dealers. Progress towards central clearing will both allow more entities to trade with each other and enhance transparency by removing the bespoke credit risk element from the pricing.

Mitigating conflicts of interest can adequately be addressed through means of disclosures and controls. Other than ensuring that the client has a full understanding of the risks assumed, is aware of any conflicts at the liquidity provider and that the trade is suitable for that client, it is difficult to see what additional protections can usefully be adopted short of disallowing the trade altogether. Regulatory initiatives (which we support) are in train to increase the standards of these protections.

We agree with the consultation paper that the implications of MiFID II on trading structures, market access and transparency and the impact of the European Market Infrastructure Regulation (EMIR) clearing obligation on product standardisation should be considered.

***In fixed income:***

**Q5: 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 believe that the regulatory authorities must strike a balance between encouraging a transparent market structure and taking into account unique trading characteristics and trading liquidity of a particular derivative. Transparency must be also balanced with the interests of all market participants, including end users, rather than serving as a mere end in itself.

We have already, over recent years, witnessed an organic shift to platform trading for appropriate products, following industry driven product standardisation and technological developments. We expect this natural shift to continue and accelerate as a result of market forces.

Additionally, as the FEMR acknowledges, MiFID II/MiFIR will bring about a significant shift in the market and a more transparent market structure.

Furthermore, until we know more about how MiFID II will be implemented and what its impact in practice will be, it would be imprudent to introduce further regulatory measures.

For example, we need to know, under MiFID II/MiFIR, what instruments will be classified as liquid and what levels of transparency will apply to these instruments.

To give another example, we understand that some concern has been expressed around whether voice broking has less of an audit trail and whether this could prevent a shift to more transparent markets. We consider this issue to be adequately addressed by MiFID II/MiFIR. In particular, Organised Trade Facilities (OTFs) will have to be authorised by the national competent authorities and will be subject to some conduct of business requirements.

We would also like to highlight that MiFIR requires the recognition of non-EU trading venues and this requires action from the European Commission (EC) and the European Securities and Markets Authority (ESMA). Article 28 of MiFIR expands on this and sets out the broad criteria for determining the equivalence of third country trading venues and where ESMA will develop Level II standards dealing with the extraterritoriality of the trading obligation. Although this process will no doubt take time, we believe that resolving cross-border issues in time for the implementation of national regulations is important as the ultimate aim is to increase the global trading of derivatives on MiFID trading venues.

Furthermore, regarding global cooperation, it may actually prove undesirable to introduce further national measures in the UK, as we are pressing for global consistency and national regulators would not usually want to place their domestic firms at a disadvantage.

As mentioned above, derivatives have unique trading characteristics. In particular, the derivative markets are made up of a limited number of participants, many of whom trade infrequently. In some cases, certain instruments trade infrequently, only a few times a year. Accordingly these instruments have very low trading liquidity and cannot be executed on an electronic screen. For these products, a voice-based system is an appropriate method of execution. We have seen in the US, many participants are on boarded to trade on SEFs but have not yet actually traded. It has also been the US experience in relation to SEFs that merely having venue trading available (and mandated for many) does not attract new participants (only a limited set of funds using algorithms in order books) to the swap markets that previously did not trade these products due to restrictive methods of execution. Therefore, pushing unsuited and inappropriate illiquid products onto electronic venues may be neither possible nor desirable. We also would like to recall that, in times of market stress, it is typically trading by voice and not via electronic venues which market participants tend to use.

We would also like to emphasise that the success of platform trading for FICC markets will depend on the willingness and capacity of market makers to continue to support markets. This will be subject to the cumulative effect of all prudential and market related regulation being introduced.

**Q6: Is standardisation of corporate bond issuance possible or desirable? Should standardisation be contemplated across a broader range of fixed income products? How that could be brought about?**

Regarding FICC derivatives markets and the question of legal, product (terms of business) and operational (eg reporting) standardisation in general we would like to make the following remarks.

Standardisation is supported by ISDA to the extent it increases efficiencies, decreases risk and reduces cost, however:

- As the consultation document acknowledges, standardisation could affect the ability of end-users to meet their funding needs (or fully hedge their exposures). As such, standardisation could come at the cost of risk mitigation.

- Any standardisation efforts must take into account the heterogeneous nature of the different FICC markets.
- Standardisation should not inhibit innovation or competition.
- We believe that with adequate controls (suitability standards, disclosure, conflict management etc.) less liquid, non-standard instruments can function in a way that meets the 'fair and effective standard'.

Standardisation is an ongoing process and has been a focus of ISDA since its inception in 1985. MiFID II will also bring further standardisation to many FICC markets, e.g. pre- and post-trade transparency, OTF/ Multilateral Trading Facilities (MTFs). However, it should be noted that standardisation cannot and should not be forced, and there are a number of reasons why certain products and transactions are not standardised, some of which are articulated in our comments below.

In the context of standardisation, we would like to mention the importance of the Financial products Markup Language (FpML) and its implications for reporting and straight-through processing (STP). FpML allows firms to settle and confirm trades electronically and removes manual processes.

There is already a fairly good level of product standardisation across both credit and interest rate derivative markets. Details can be provided on request but in summary they include:

<u>Rates</u>

Certain standard features i.e. combination of pay and receive frequencies, resets, day counts and constant notionals bring some benefits. Such standardisation can result in reduced trade populations (with the increased ability to compress trades), lower notional and less burdensome capital charges, swift pricing and execution, as well as ease of novation or the ability to exit a trade.

However, standardisation may reduce the ability to hedge *bespoke* risks such as projected asset and liability cash flows (amortising notional matches, scheduled loan paydowns, estimated prepays or project cash flows, alignment of resets, customised payment frequency, floating rate spread, ability to tailor start and maturity dates) or funding cost indices that may be more difficult to 'normalise' in the contractual terms of 'basic products' and thereby impact accounting treatment and the ability to reduce profit and loss volatility.

In addition, Market Agreed Coupon contracts exist to complement more bespoke interest rates swaps (IRS) arrangements. These contracts provide for IRS trading on pre-defined market agreed terms and are aimed at promoting liquidity and enhancing transparency in IRS trading.

<u>Credit</u>

The credit derivatives market is already very standardised, with standard roll dates, coupon rates and standard terms. In addition, the auction process and Determinations Committee to determine and facilitate settlement of a credit event was hardwired into contracts and has operated successfully since 2009.

In addition, the 2014 ISDA Credit Derivative Definitions provides for the standardization of Reference Obligations, by allowing for a "Standard Reference Obligation" to be published for a specified Reference Entity and Seniority Level.

The credit default swap (CDS) market now benefits from robust and transparent processes, consistent transaction terms which, in this market, facilitates risk management, clearing and other processes, reduces trade-level confirmation information and reduces trade breaks.

Beyond product standardisation, ISDA continues to support the industry to establish standardisation of legal terms to describe products and their associated confirmations. This can take the form of standard language for reference rates and standard terms and processes around exercise of options and reset of notionals, among other things.

On the issue of standardisation of corporate bond issuance, we defer to the International Capital Market Association's (ICMA) and the Association for Financial Markets in Europe's (AFME) responses.

**Q7: 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 support the ICMA and AFME response to this question.

***In foreign exchange:***

**Q8: Are there risks associated with internalisation and last look practices? Are there barriers preventing increased pre and post-trade transparency in foreign exchange markets?**

**Q9: Are there barriers impeding the development of more comprehensive netting and execution facilities for transacting foreign exchange fix orders?**

We support Global Financial Markets Association (GFMA) FX Division in this context.

***In commodities:***

**Q10: Are there any material barriers preventing greater transparency in OTC commodity derivatives markets? If so, what could be done to remove them?**

As the FEMR acknowledges, MiFID II/MiFIR and EMIR will bring about a significant shift in the market and a more transparent market structure.

With the implementation of EMIR (specifically its provisions on reporting to trade repositories) and of MiFID II (specifically its provisions on post-trade transparency and position reporting to regulators for the purpose of position limits rules), transparency vis à vis the regulators and market participants of commodity derivatives markets is in our view sufficiently addressed.

MiFID II will also introduce the category of OTFs, which will ensure that screen- or voice-brokered platforms used for commodity trading will have to be authorised by national regulators, be subject to organisational requirements and comply with rules on the transparency of trading processes and the execution of orders.

Only once MiFID II/MiFIR has bedded down will it be possible to assess the existence of gaps and the need for further intervention. Any earlier action would be imprudent and would risk disrupting ongoing implementation work. We believe that the effectiveness of transparency measures (especially in order to avoid market manipulation) depends on the features of the underlying physical commodity markets rather then the derivatives business per se. In particular, the availability of reliable data on physical markets (i.e. the deliverable supply of underlying commodities) is crucial to ensure effective transparency.

In this respect, metals are subject to storage and inventory rules.

- Energy products (natural gas and power) are subject to robust sector regulations at both European and national levels. With regard to natural gas and power, it is also worth noting that the implementation of the Regulation on Wholesale Energy Markets Integrity and Transparency (REMIT) is still ongoing and that the reporting of all transactions and fundamental data to European regulatory authorities, which will be finalised by early 2016, is expected to substantially improve transparency in these markets.
- On the other hand, physical agriculture markets are not transparent and when countries have a dominant position in certain commodities (e.g. cocoa, rice, corn, coffee, sugar) the level of transparency (vis-à-vis, for example, production, storage) is not sufficient.
- The same issue appears for Rare Earths, e.g. Zircon, Titanite, Fluorite, Britholite (95% of the production being China). Global transparency in these physical markets is needed and should be subject to G20 commitments.
- For oil there continues to be opacity around production (forecast and actual) from certain state owned oil companies. The effort behind the Joint Oil Data Initiative (JODI) is to be welcomed in this regard, however it would be preferable if the UK continued in relevant international fora to encourage further development and improvements.

To underline the global consistency issue already mentioned above, we would like to suggest that the UK authorities consider whether any potential issues are UK specific or European or global in nature. This is a fundamental element to consider before introducing further measures in the UK or internationally, as we are pressing for global consistency.

***Regulatory measures:***

**Q11: 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?**

ISDA considers that more consistent data reporting standards, trading protocols and platforms that aggregate liquidity (rather than fracture it) are necessary. Similarly the market needs consistency in rules surrounding clearing mandates and OTC margining. We would refer you to the FSB's paper (mid September 2014) which stressed the need for regulators to defer to other countries' regulatory regimes.

We would like to refer to our response to Q 2 and highlight the following examples where inconsistent approaches to the scope and application of regulatory initiatives have created issues of fragmentation, duplicative and/or conflicting requirements and potential for regulatory arbitrage.

(a) EMIR equivalence requirements – delays in resolution creating problems in relation to clearing requirements, extraterritorial application of the secondary legislation and intragroup exemptions.
(b) MiFID II/MiFIR – reciprocity requirements which will create trading issues for EU entities.
(c) Banking Structural Reform (BSR) – uncertainties created by equivalence and reciprocity requirements in the current draft of the proposed legislation.
(d) Financial Transaction Tax - broad extraterritorial application of the proposed legislation.
(e) Dodd-Frank Act (CFTC) – "first mover" issues on trade execution mandate, SEF requirements, trade reporting.

For more details, please also see our responses to Q 14 and 16.

## Conflicts of interest and information flows

**Q12: Where do potential conflicts of interest arise in the various FICC markets, and how do they affect the use and potential abuse of confidential information, both within and between firms?**

Please see Q 13.

**Q13: How can the vulnerabilities posed by such conflicts be reduced? Are existing internal structures and control procedures sufficient? Where they are not, are further internal management controls required (such as better trading floor design and/or closer monitoring of electronic communications within and between firms) or is more radical action required to remove conflicts altogether?**

On both Q 12 and 13:

We agree with AFME that potential conflicts of interest are already addressed by the Market Abuse Regulation (MAR) and investor protection rules under MiFID II/MiFIR (please also see our answer to Q 28).

We would like to add that MAR extends the scope of market abuse rules in terms of products and markets. In particular MAR includes rules on Chinese walls, investment research and surveillance and reporting of suspicious transactions as well as the new provisions on market soundings. We believe that in the coming years the focus should be on the implementation of and compliance with the new rules (MAR as well as the review of the UK market abuse framework). In addition, under MAR it is already required that the EC reports on the application of this regulation, together with a legislative proposal to amend it if appropriate, by July 2019. This would include a mapping exercise of administrative and criminal sanctions.

Moreover, we believe that MAR is the preferred instrument to address the conflict of interest problems rather than the EU Banking Structural Reform and UK Ringfencing legislation, as we think that their primary political goal is to deal with the 'too-big-to fail' issue; and the scope of MAR is much larger than any BSR regulation, which would probably only capture the largest banks.

ISDA

## Competition and market discipline

**Q14: Is there a relationship between the level of competition in FICC markets globally and the fairness and effectiveness of those markets? What risks are posed by the increase in concentration seen in some FICC markets? In answering this, please have regard to the geographical scope of any relevant markets.**

We agree that more competition in markets is likely to improve the fairness and effectiveness of markets as it lowers prices and improves choice.

We sympathise with concerns around the increase in concentration seen in some FICC markets, however, increased concentration is likely to be relatively short lived if new competitors can enter the market.

Regulatory barriers can segment markets, in particular cross-border. We believe that inefficient third country regimes lead to balkanization, as witnessed with the introduction of SEF rules in the US. Evidence has emerged that OTC derivatives markets have fragmented along geographical lines since the start of the SEF regime in the US on October 2, 2013. That trend has been especially notable for euro interest rate swaps, with European dealers opting to trade with other European parties. This development has accelerated since the start of mandatory SEF trading in the US from February 2014, and the market for euro interest rate swaps is now clearly split between US and non-US counterparties (see Revisiting Cross-Border Fragmentation of Global OTC Derivatives: Mid-year 2014 Update, ISDA Research Note, 24 July 2014).

Please also refer to Q 2.

***Promoting effective competition through market forces***

**Q15: To the extent that competition is currently ineffective in any of the FICC markets, are there market-led initiatives, technological or structural changes that may remedy this situation?**

ISDA continues to provide forums to listen and respond to opportunities to improve the market, make it fair and efficient, and find opportunities for increased standardisation.

As AFME highlights, transparency and competitiveness will also be strengthened as MiFID II/MiFIR enhances data and reporting requirements.

**Q16: Are there any lessons that can be drawn from experiences in other financial markets (or indeed other markets) about the ways that alternative or evolving market structures could impact on competition in FICC markets?**

Cross-border issues have arisen on the back of the derivatives reforms in the US and in Europe in relation to fragmentation of global markets. For instance:

- The lack of clarity around the introduction of SEFs and application of the Dodd-Frank Act to non-US swap dealers operating on US SEFs has led to shifts in liquidity pools, thus affecting the global level playing field.
- The ongoing EU process of the recognition of non-EU CCPs is creating market uncertainty.

- The differences between EU and US public transparency regimes (eg. regarding request for quote systems and post-trade deferral periods and volume caps) may create an unlevel playing field.

We are concerned that regulatory regimes will continue to have differences for as long as Level 1 legislators set the basic Level 1 text to have different requirements from other existing extra territorial regimes. For example, the MiFID II/MiFIR Level 1 text is now set in stone and cannot converge with the US regime in some areas. There should be greater involvement of international global regulatory bodies at Level 1 to ensure that this does not happen. Please also refer to Q 2.

**Q17: How effective is market discipline in enforcing sound market practices in each of the key FICC markets? What could be done to strengthen it?**

As highlighted by AFME, in general, market discipline will be enhanced by MiFID II/MiFIR and Market Abuse Directive (MAD)/MAR.

Feedback from ISDA members has focused on commodity markets.

In Commodities markets, exchanges (LME, ICE, Liffe) have implemented position management regimes that have proved effective and the European Union is about to implement a position limits regime through MiFID II.

With such a position limits regime (provided that it is appropriately designed with regard to the netting of positions, the hedging exemption and the measure of the deliverable supply that will serve as a basis for the expression of limits), the European Union will be introducing a robust regulatory regime and we believe the priority should be allowing these rules to bed in.

However, transparency in physical markets is critical and ISDA members would support the extension of JODI database to agriculture commodities or Rare Earths at international level (G20 and beyond). See our response to Q 10.

***Promoting effective competition through regulatory and legislative initiatives***

**Q18: In what ways might competition in any of the key FICC markets usefully be addressed by competition authorities (eg by assessing the state of competition in relevant markets)?**

The FCA has already commenced a review of competition in the wholesale financial markets sector to identify any areas that might merit further investigation through an in-depth market study. A feedback statement is expected with any market study merited by the feedback to be launched early this year. As such, we consider that initiatives are already in process to assess the state of competition in the markets and to seek to address any perceived issues arising from such assessment.

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

We await the feedback statement from the Financial Conduct Authority (FCA), mentioned in response to Q 18 above. However, we are not aware of any specific additional regulatory reforms that could be helpful in promoting competition and market discipline beyond those already being implemented, and other than (as noted in response to Q 1, 14 and 16 above) in relation to the recent regulatory reforms that might have increased or created further barriers to entry. As the FEMR consultation paper recognises, regulation can prevent new entrants from entering the industry. Nevertheless, and as mentioned above, participation requirements should be robust to ensure safety and efficiency of markets. Policy makers should therefore seek to ensure that regulatory regimes achieve their purpose but do not hinder new entrants unduly.

**Q20: Is there a need for better awareness and understanding of the existing competition framework among FICC market participants, both at firm and individual level? How do you think that might be best achieved?**

We support awareness and understanding of applicable competition frameworks among FICC market participants. Training is an essential part of this, together with appropriately distributed internal procedures for reporting any concerns or raising any questions concerning the application of competition laws.

## Benchmarks

**Q21: 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 welcome a number of current and recent regulatory and industry initiatives (eg UK, EU and IOSCO initiatives as well as GFMA Principles) to improve the robustness of benchmarks and we have been engaging to make benchmarks safe and efficient. We would strongly recommend finalising the numerous current reforms (as well as their details and implementation) and assessing their impact first in order to be in a position to assess whether there is a need for further measures. We would also like to emphasize the need for global consistency, based on IOSCO principles, including both Oil Price Reporting Agencies (PRAs) IOSCO Principles and IOSCO principles for financial benchmarks.

***Industry-level measures***

**Q22: What steps could be taken to reduce the reliance of asset managers and other investors on benchmarks?**

We defer to the views of other relevant trade associations on this issue.

**Q23: What additional changes could be made to the design, construction and governance of benchmarks?**

Many benchmarks have been subject to numerous changes, driven both by regulators and industry. Several reforms are yet to be finalised or implemented, including on design, construction and governance of benchmarks, for instance at both IOSCO and EU levels. We would suggest finalising these initiatives and analysing their impact before considering new ones.

More precisely and in light of the FSB report on Reforming Major Interest Rate Benchmarks (http://www.financialstabilityboard.org/wp-content/uploads/r_140722.pdf?page_moved=1), we support the establishment of a group, coordinated by the Bank of England, to develop robust risk free rates that could be used to support derivatives.

**Q24: Should there be an industry panel to discuss benchmark use and design with the aim of assisting industry transition?**

The primary concern from our members relates to the transition from old to new rates. Firms appear in favour of clean switches to new rates rather than gradual transition periods with dual publication as this just causes confusion. We also believe that implementation and adoption by way of legislative acts can be helpful to avoid confusion and risk of fragmentation. Additionally, upfront analysis and planning appropriate implementation is necessary to reduce the risk of legal frustration and minimise unintended consequences eg significant risk due to sudden major market dislocation. In order to achieve this, provisions need to be made for legacy transactions where appropriate. Moreover, lining up business drivers with legal and implementation issues is critical.

***Regulatory action***

**Q25: What further measures are necessary to ensure full compliance with the IOSCO Principles for financial benchmarks by all benchmark providers?**

Since IOSCO principles are not directly applicable, they need to be replicated in regional legislation. The EU proposal on benchmarks aims to transpose the IOSCO principles which will ensure consistency in Europe. However, two concerns have to be addressed: a) recognition of third-country benchmarks and b) differentiation between financial benchmarks and commodity benchmarks.

(IOSCO has published two sets of principles, the first one on Oil PRAs, the second on financial benchmarks and in a recent report on the implementation of these sets of principles (September 2014), IOSCO made clear that it is not considering alignment of these two sets of principles. It is considering extension of Oil PRA principles to other commodity benchmarks. We expect a report in mid-2015.)

Consistency in the application of the IOSCO principles is important and the EU proposal on benchmarks should not 'gold-plate' the IOSCO principles.

In particular, we would suggest considering the following issues to ensure full compliance with IOSCO principles:

- More coordination among national competent authorities via regular meetings and specific forums chaired by IOSCO on key issues of the principles (equivalent supervision of third-country benchmark administrators, proportionality, etc.), with the goal of establishing common ground.
- When possible, more granular and detailed IOSCO principles, which would allow them to be transposed easily to national legislation.
- Agreeing a minimum set of principles to be implemented in a homogenous way by all jurisdictions (i.e., third-country regime).
- Closer communication and relationships between IOSCO and the jurisdictions adopting a legislative framework on benchmarks (EU, Japan, Singapore, etc.), for instance, via IOSCO expert meetings and advising relevant policy-makers on regular basis throughout the legislative process.

- Organizing a set of meetings (focusing on different issues) to discuss how the IOSCO principles have been implemented after the publication of the assessments in 2015.
- Mapping agreements and disagreements between IOSCO principles and the national legislation once they are enforced. This would identify aspects of the domestic law that are either stricter or less strict than IOSCO principles.

Lastly, we would like to underline that the principle of 'proportionality' embedded in IOSCO principles should be accordingly reflected in implementing regional legislation since different benchmarks are subject to diverse risks and regulatory concerns. For instance, while a failure of an IBOR may impact the financial stability of the EU and affect a multitude of customers (e.g. households), customised indices are available to a restricted number of specific, more sophisticated clients looking for bespoke investment products and are not accessible to the wider public.

**Q26: How can the regulatory framework provide protection to market participants for benchmarks administered in other jurisdictions in a proportionate way?**

We believe that this could be achieved in several ways, for instance by strengthening cooperation between EU and non EU regulators and competent authorities in terms of exchange of information, seconding officials, forums of discussion and other measures to enhance dialogue. Additionally, via analysing and developing when possible the extraterritorial aspects of MAR and MAD and addressing divergent application of the IOSCO principles eg in Europe and Asia. Finally, by clarifying the meaning of the term 'benchmarks' across jurisdictions for legal certainty purposes.

We would also like to reiterate our point made in response to the last question and urge regulators to implement the IOSCO principles in a consistent manner and engage in a frank and open discussion between various competent authorities on this point. We are concerned that for example, the Monetary Authority of Singapore (MAS) is proposing to regulate submitters of key financial benchmarks. The IOSCO principles for financial benchmarks 1 and 2 clearly assign responsibility to the administrator of the benchmark and do not recommend direct regulation of third parties or submitters.

We also welcome the idea of the industry panel and defer to AFME and BBA responses for detail.

## Standards of market practice

**Q27: 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?**

Please see our response to Q 29 and 30.

**Q28: 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?**

Principal v agency capacity

We believe that clarity regarding when a firm is acting in a principal or an agency capacity has been provided by MiFID II/ MiFIR. A clear distinction is made as to what is multilateral and bilateral trading and in which conditions a firm can trade bilaterally. As a consequence there is a clear divide between agent trading (executing orders on behalf of others without using one's own balance sheet) and principal trading (trading on own account, using one's own balance sheet). Furthermore, where firms execute trades on behalf of a client, the client is informed about the way in which and where trades are executed (on or off trading venues). Therefore we do not think that any further regulatory action is needed in this regard.

Legitimate trading activity and inappropriate front-running, internal and external communication of market activity and the risk of market manipulation

ISDA welcomes the Reports' acknowledgment that it is often difficult to discern between legitimate trading activity and market manipulation and that in the absence of clear rules otherwise legitimate activity may be constrained by a concern that (1) such trading could be misconstrued as front running and/or (2) legitimate information sharing (either internal or external) could be misconstrued as market manipulation.

In our view ESMA's draft MAR implementing measures on indicators of market manipulation and accepted market practices are neither clear nor precise enough and risk making it more difficult for market participants to ensure they comply with the market abuse regime. We therefore believe it is necessary for ESMA and the EC to continue to engage with market participants to ensure that the implementing measures provide the requisite legal certainty.

Client suitability

On selling practices, we note that the FEMR's focus is very much on inconsistent standards with regard to suitability tests. We believe that while client suitability assessments will always require some degree of flexibility, MiFID II and the Packaged Retail Investment Products (PRIPs) Key Information Document (KID) requirements (building on MiFID I regime) may go some way to addressing FEMR concerns. We are taking a holistic view here, including both wholesale and retail markets.

MiFID I created the suitability and appropriateness tests in the 'investor protection' section. In particular, MiFID I has created an EU harmonised regime based on criteria for determining client classification but in the end the client has a right to opt down (i.e. to be treated as non-professional even though the strict application of the regime would lead the intermediary to consider him as a professional or an eligible counterparty).

MiFID II confirms the regime created in 2007 and adds two sets of rules: a) more stringent classification of products between simple products (eligible to execution-only service) and complex products, notably with a split between complex and non-complex Undertakings for Collective Investment in Transferable Securities (UCITS), complex UCITS being subject to investment advice (i.e. not eligible to execution-only service); b) creation of 'on-going' advice that applies for the whole life of the product.

We believe that client suitability assessments will always require a degree of flexibility – it is not a tick box exercise and it certainly should not become one. The new Product Governance arrangements in MiFID II and the PRIPS KID requirements may go some way from shifting the conduct of business focus from the point of sale suitability tests to a more holistic view of the market where both the product manufacturer and product distributor each have their own obligations with respect to identifying the correct target market for their product and keeping abreast of the customer experience with a product. It is difficult to see how any action that the UK authorities in this space would not lead to a broadening of the differing standards in various jurisdictions.

On allocation of new issues, ISDA defers to ICMA and AFME.

**Q29: 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?**

In general, we support a mix of (a), (b) or (c) depending on the exact area of uncertainty.

For education to be effective the applicable standards need to be clear. Harmonisation and simplification of regulation with consistent language and definitions would help.

We think that there would be merit in the industry reviewing existing codes of conduct with a view to revising and/or consolidating where appropriate. We consider that this should be a task for industry practitioners who are best placed to highlight, address and respond to perceived uncertainties and the needs of the relevant markets.

Once in force, such codes should be owned and maintained by the market to ensure they remain dynamic and adapt to market developments.

It has also been suggested that a consultation board or facility to give interim guidance on best market practice should be established to address any new uncertainty that may arise until such time as the necessary political processes required to update any formal code can be completed.

***Will these uncertainties be dealt with by current reforms?***

**Q30: How can the industry, firms and regulators improve the understanding of existing codes and regulations by FICC market participants and their managers?**

In addition to the suggestions proposed in response to Q 29 above, training is an important aspect of improving understanding. ISDA is very experienced in providing conferences for the benefit of the industry and could facilitate in any education programme to increase awareness and understanding of applicable codes.

**Q31: 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?**

We agree with the principle of upholding competences and testing them. However instead of compulsory examinations we would suggest in the first place reviewing the existing best practices of internal processes built to ensure that staff have appropriate competences and understand existing standards.

***Can the industry help to establish better standards of market practice?***

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

If a gap in regulation is identified, market codes can help to establish guidance as to best practice. Where standards already exist, any additional layer can cause confusion and unnecessary complexity.

Market codes could be seen as more flexible and capable of being updated more easily to track market innovation. Also, where developed by industry, they can be developed in language more accessible to the relevant market participants.

**Q33: How would any code tackle the design issues discussed in Section 5.4.3, ie: 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?**

Where a market code is deemed necessary, if developed and maintained by industry, it stands most chance of meeting and tracking market expectations and addressing real market concerns. It is also likely to be phrased in language more accessible to trading teams. Whether or not to customise it for individual asset classes should depend upon the particular issue(s) being addressed and market feedback.

The framework is already in place to substantiate any market code (e.g. FCA Principle 5 and generally regulatory oversight). ISDA does not consider that it would be appropriate to include contractual undertakings to comply with a market code directly into their contracts with market counterparties. To do so could create market disruption and/ or depending upon the circumstances, even systemic risk which is something that the markets have been working hard to avoid over the last few years. It would also lead to legal uncertainty with the issue of compliance with the relevant code(s) made a matter for the parties to interpret.

To the extent that a market participant is able to continue to perform its obligations under a contract, it should do so. Obviously, to the extent that the market participant is no longer able to perform according to the contract, the contract would provide the appropriate remedies for that.

To the extent that a market participant is separately guilty of failing to meet applicable market standards, separate appropriately targeted action should be taken against that market participant without otherwise impacting the market.

***Should the scope of regulation be extended?***

**Q34: In the context of implementing MiFID 2, which of the FCA Principles for Businesses should apply in relation to MiFID business with Eligible Counterparties?**

Principles 1, 2 and 7 should be brought into scope (principle 7 already partially applies). Principles 1 and 2 broadly match with the MiFID requirement for market participants dealing with Eligible Counterparties (ECPs) to act 'honestly, fairly and professionally'. Principle 7 broadly matches 'fair, clear and not misleading'.

**Q35: 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?**

The scope of commodity contracts that are in the scope of MiFID has always been uncertain, particularly regarding physical forwards traded on platforms that are registered as MTFs (under MiFID I). Similar uncertainty applies for contracts traded on platforms that will be registered as OTFs (under MiFID II). Market participants want legal certainty and want to know precisely the remit of the definition of financial instruments under MiFID.

As long as market participants do not have a list of platforms registered as OTFs under MiFID II it is difficult to assess whether the scope of financial instruments under MiFID II is too large or too narrow. Our members are very clear that financial regulation must apply to contracts that are financial by nature but in their view, it is inappropriate to apply the same principles to contracts that are commercial by nature in the sense that they are primarily for the physical supply of the underlying commodity (and the inclusion of events such as the default of a counterparty or force majeure do not alter the commercial nature of these contracts even though it may prevent physical settlement).

## Responsibilities, governance and incentives

**Q36: 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?**

***Firm-wide initiatives to improve incentives and governance***

**Q37: 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?**

***Market wide initiatives to align market conduct, incentives and governance***

**Q38: 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?**

***Regulatory initiatives to improve governance and incentives***

**Q39: 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?**

On Q 36-39, we agree with the FEMR consultation paper that recent market abuses demonstrate the critical and important role of management and compliance oversight of market conduct by firms and the need to ensure that incentives are appropriate. For detailed responses ISDA defers to AFME.

## Surveillance and penalties

**Q40: 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?**

On Q 40 – 44, we refer you to our response to Q 47 and Q 31.

***Firm level surveillance***

**Q41: 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?**

***Firm level penalties***

**Q42: 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)?**

**Q43: 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?**

***Regulatory level surveillance and supervision***

**Q44: Is the current supervisory approach and level of intensity dedicated to supervising conduct within the UK wholesale FICC markets appropriate?**

**Q45: 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?**

ISDA's understanding of the purpose of MiFID transaction reporting is to allow the FCA (and other European Economic Area (EEA) competent authorities) to perform market surveillance of securities markets to promote safe markets and detect instances of market abuse. We would like to note the extension via MiFID II/MiFIR of transaction reporting to wider classes of derivatives. We believe that this regime will provide the data required to monitor market trading behaviour in FICC markets, in addition to the data already being provided by firms via EMIR reporting of derivative transactions.

As MiFID II/MiFIR expands to cover more derivative transactions, firms which have already expended resources on EMIR reporting are anxious that all possible synergies with the incumbent EMIR reporting regime are exploited e.g. data standards and specifications should be the same where possible.

EMIR trade reporting requirements for derivatives are very extensive and give the FCA access to all trade information. ISDA welcomes ESMA's current consultation on the EMIR reporting technical standards and with those the efforts of the FCA to work with the industry to aid understanding of new publications and proposed requirements. ISDA continues to meet regularly with the FCA to understand concerns of the FCA about potential deficiencies in reported data. We also make them aware of industry work to standardise reporting approaches and try to understand if industry efforts are in line with the FCA's priorities. This interaction works very well and ISDA feels these continuing efforts will see the data reported under EMIR improve further so that it can be used for many regulatory purposes where applicable.

Trade Repository reporting is a global requirement to reduce systemic risk. The FCA should continue to work with other regulators in Europe and beyond to increase data consistency and quality. The FCA should not look now to expand the regulatory perimeter of EMIR or MiFID reporting to include entities or products which are outside the scope but instead first ensure equivalence of EMIR reported data to data reported in other jurisdictions via global standards. Any potential future additional data requirements should be subject to a cost/benefit analysis. Primarily it is important for ISDA's members to get EMIR reporting to work efficiently and with standardisation across other reporting regimes in other jurisdictions. The FCA could facilitate this by endorsing industry work on global identifiers, taxonomy and FpML data standards which ISDA has been engaging global regulators on. ISDA are happy to assist the FCA with any data queries they have as mentioned above.

On bond standardisation, we defer to other relevant trade associations.

***Regulatory-level penalties***

**Q46: What further steps could regulators take to enhance the impact of enforcement action in FICC markets?**

**Q47: 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?**

On Q 40-44 and 46-47, we would like to highlight the introduction of MiFID II and MAD II packages in 2016 and 2017 as they address the discussed issues. Regarding MAR there are a number of important Level 2 implementing measures that are currently being developed by ESMA and national regulators and where drafts are expected to be sent to the EC by 3 March and 3 July 3015. We would urge regulators to ensure that these measures are developed in a way that ensures their effectiveness. For instance, it is important that the modified rules on suspicious transactions reporting are suitable for the broadened scope of asset class covered and that these rules take into account reporting standards developed under EMIR, MiFID II and REMIT. For more details we refer to the ISDA response to the July-

October 2014 ESMA consultation on MAR Level 2 measures (http://assets.isda.org/media/4b817a3e/921ea23e.docx).

For detailed answers to the specific FEMR questions raised in the surveillance and penalties section we defer to the AFME FEMR response.

**Q48: Is there a need to widen and or strengthen criminal sanctions for misconduct in FICC markets?**

**Q49: 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?**

For Q 48-49 we agree with the British Bankers' Association's (BBA) response.

In general we welcome global harmonisation of rules.

We also condemn market abuse, and welcome the introduction by the Criminal Sanctions Market Abuse Directive (CSMAD) of a Europe-wide criminal market abuse regime. We also believe that firms that fail to put adequate anti-market abuse systems and controls in place and thereby allow market abuse to occur should be liable to tough penalties. Such penalties play a very important role in ensuring that market participants invest in robust anti-market abuse systems and controls.

In this context, as the UK government considers whether the UK rulebook approach needs to be modified, inter alia given the adoption of CSMAD, we believe that in the criminal space in the UK there exists or is impending a sufficient criminal sanctions regime to cover the areas of market abuse subject to investigation over the last few years. ISDA agrees that appropriate deterrents should be in place. We do not see the need for new criminal sanctions relating to CSMAD or generally. We would also like to mention the confirmation in late December 2014 of the extension (from April 2015) of the s91 FS Act offences (of misleading statements or impressions relating to benchmarks) to the seven FICC benchmarks identified by the FEMR. This should be a useful addition to the UK regime against financial crime in FICC markets. Article 5 of CSMAD contains similar offences (regarding benchmark manipulation) so the extension of the s91 offences lessens the case somewhat for subsequent UK copying CSMAD.

The current UK enforcement regime already enables regulators to impose penalties on firms that fail to prevent and detect market abuse. We believe the current UK enforcement regime is robust and provides a credible deterrent against firms failing adequately to invest in anti-market abuse systems. Currently a firm's failure to prevent and detect market abuse is punishable in the UK only under the civil regime (i.e. by the FCA). However, in parallel with the FEMR consultations, in September 2014, the Attorney General (Jeremy Wright QC) announced that the UK government is looking at whether to create a new corporate offence of failing to prevent economic crime – akin to that under s7(1) of the Bribery Act. There is of course a defence to the corporate Bribery Act offence under s7(2) if the corporate can show that it had adequate measures to prevent bribery. It appears that whilst the extension of the s7 regime to all economic crime would be extremely onerous, it would be preferable to the introduction of an offence akin to that in Article 7 of CSMAD as the Article 7 CSMAD offence does not have an adequate measures defence (as is noted below).

Articles 7 and 8 of CSMAD require EU Member States to make a legal entity liable to “criminal or non-criminal” fines or other serious sanctions where criminal market abuse is committed for its benefit and (a) the offender held a “leading position” within the legal entity or (b) the offence was made possible by a lack of supervision or control by such an entity. Article 7 provides that a person will be treated as having a “leading position” based on a power of representation, authority to take decisions or authority to exercise control.

The policy purpose of Articles 7 and 8 of CSMAD, given by the EC, is that it is appropriate to fine a firm where a market abuse offence has been committed for its benefit and that the imposition of a penalty “could … encourage financial institutions to take the organisational measures and provide the staff training necessary to prevent violations”.

Whilst we fully support the policy objective intended by Articles 7 and 8 (as important principles already enshrined in the UK current enforcement regime), we have two principal concerns.

First, we are concerned that Articles 7 and 8 do not provide an incentive for firms to invest in such systems. Many jurisdictions that make corporates criminally liable for acts committed by their officers or employees have put in place mitigants, such as ‘adequate procedures’ based defences. However, under CSMAD there are no such mitigants on the face of the text. A firm at which market abuse is committed by a person with a ‘leading position’ may be liable under Article 7 (1), even if the firm can demonstrate it had robust anti-market abuse systems and controls in place when the market abuse was committed. This appears to run counter to the stated policy purpose of Articles 7 and 8.

Second, we are concerned that the scope of Articles 7 and 8 is unclear. It is presumably intended that only the senior management of a firm (such as directors or de facto directors) will be treated as holding a ‘leading position’. However, Article 7 could be misread as treating more junior employees as holding such a position given that (for example) a trader will typically have authority to make certain representations and enter into trades on behalf of a firm. While it is clearly right that any individual (however junior) who engages in criminal market abuse is personally subject to criminal sanctions, we believe it is important for the purposes of establishing corporate liability that the definition of ‘leading position’ is clear.

In the light of these concerns we believe that, as the Government considers whether to modify the current UK criminal market abuse regime, inter alia given the adoption of CSMAD, it should consider the importance of:

(a) Clarity that a legal entity will not be held liable for the article 7 like offences if the legal person can demonstrate that, when the relevant market abuse offence was committed, it had adequate systems and controls designed to ensure that persons acting for its benefit did not engage in market abuse. This is consistent with the approach adopted by the UK to corporate liability for bribery in section 7 of the Bribery Act 2010 and is in line with achieving the stated policy purpose of Articles 7 and 8.

(b) The English common law ‘controlling mind and will’ test regarding criminal liability for the Article 7 like offence.

(c) Clarity that an individual is only treated as holding a ‘leading position’ within a legal entity if the individual manages or directs the legal entity, or a significant business unit of the legal entity.

As a final point, we would welcome the opportunity to discuss with you the jurisdictional scope of Articles 7 and 8 of CSMAD. We would particularly like to underline the importance of maintaining a clear demarcation of responsibility for the oversight of firms' anti-market abuse systems and controls between regulatory authorities in different EU Member States.