

ISDA response to the UK FCA Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5 - 5 Feb 2018

We welcome the opportunity to respond to the UK Financial Conduct Authority (FCA) Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5 (CP17/37). We would welcome the continuation of the FCA's dialogue with the industry as responses to the consultation are reviewed and further consultations are potentially considered.

The goal of the current consultation, as cited by the FCA, is to 'encourage [...] appropriate standards in unregulated markets.' This is consistent with the International Swaps and Derivatives Association's (ISDA) own mission of ensuring safe and efficient markets.

Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 875 member institutions from 68 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Associations' web site www.isda.org.

Executive summary

ISDA agrees with the fundamental importance of integrity to underpin markets. If a gap in regulation is identified, with regard to markets or activities covered, industry codes can help to establish guidance as to best practice in unregulated markets.

Therefore, we welcome the FCA consultation on codes of conduct.

We also agree that one of the goals of the proposals should be to increase certainty in the market as to how standards should be considered by market participants – eg, in terms of their voluntary character.

In this context, ISDA would also like to emphasise several themes in the response to the consultation, including encouraging codes of conduct, clarifying which types of unregulated markets and activities that the FCA envisages should be covered by recognised codes, taking into account cross-border nature of markets, the need for clarity on supervision and enforcement, as well as efficient criteria and process for recognition.

We would like to stress the importance of further work, ideally through another consultation, to clarify several key aspects of the FCA proposals to recognise codes of conduct and to ensure that the FCA's proposal, in practice, achieves its stated aims.

We would also welcome further consideration by the FCA of its proposals regarding the merits of a possible extension of Principle 5 to cover unregulated activities.

FCA's general approach to Industry Codes and unregulated markets

Q1: Do you agree that the FCA should support the take-up of industry codes through the general approach described? If not, how should the FCA consider codes for unregulated markets developed by industry practitioners?

We agree with the fundamental importance of integrity to underpin markets. We also agree that equilibrium is needed – ie, end user interests should be protected and the effectiveness of the markets ought to be ensured as well.

If a gap in regulation is identified, with regard to the scope of markets or activities covered, market codes can help to establish guidance as to best practice. Where standards already exist, any additional layer can cause confusion and unnecessary complexity (unless the goal of the code is set to suggest, for an already regulated market or activity, a higher level of standard than a minimum regulatory requirement)¹.

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.

Therefore, we welcome the FCA consultation on codes of conduct. We also agree that one of the goals of the proposals should be to increase certainty in the market as to how such recognised standards should be considered by market participants – eg, regarding their voluntary character.

ISDA would also like to emphasise several themes in the response to the consultation, including encouraging codes of conduct, clarifying which types of unregulated markets and activities that the FCA envisages should be covered by recognised codes, taking into account cross-border nature of markets, the need for clarity on supervision and enforcement, as well as efficient criteria and process for recognition.

For more details, please also see our responses to Q 1A, 2, 3, 5, 6. In particular, we would like to highlight a number of areas for improvement as outlined in Q3, 5 and 6.

Q1A: Do you think we have been sufficiently clear about how we will view industry codes of conduct in our regulatory activities, including supervision and enforcement? If not, what further questions do you have about our general approach?

Please also see our answers to Q3 (on supervision and enforcement) and Q1 and 2 regarding further comments on the FCA general approach.

¹ We appreciate that the FCA is consulting on codes of conduct for unregulated markets. However, some existing codes of conduct cover regulated markets, eg FSMB codes in the area of fixed income. These codes set out 'good' conduct, that is quite ambitious and sets higher standards than the regulatory minimum requirement. Should there any changes be considered to the status of such already existing standards, they may need to be redrafted.

Recognising Codes

Q2: Do you agree with our proposal to recognise certain industry codes of conduct in unregulated markets? If not, please provide your reasons.

The framework is already in place to substantiate any market code (eg, FCA Principle 5, generally regulatory oversight, and the Senior Managers and Certification Regime (SM&CR) expecting individuals to “observe proper standards of market conduct” in regulated and unregulated activities). The FCA consultation is discussing on how to encourage the adoption and compliance with market codes even further – in particular, via a formal FCA ‘recognition’ process.

We welcome the FCA proposal to encourage codes of conduct (although we note several concerns with the recognition process, as outlined below), especially as ISDA does not consider that it would be appropriate to include *in contracts* a requirement that undertakings should comply with a market code (as previously discussed under the 2014-2015 UK Fair and Effective Markets Review (FEMR)). Such requirement could create market disruption, systemic risk and legal uncertainty. We welcome that the FCA is still of a mind not to pursue this route.

We also welcome the FCA’s general intent to clarify how obligations to observe proper standards of market conduct may be met under the SM&CR for unregulated markets. However, with regard to the FCA proposal to recognise codes, we would highlight a number of concerns as outlined in our answers to Q3, 5 and 6.

Regarding other general benefits of codes of conducts for unregulated markets, please also see the answer to Q1.

Q3: What challenges do you foresee for the FCA or industry with recognising certain industry codes?

We would like to stress the importance of further work, ideally through another consultation, to clarify several key aspects of the FCA proposals to recognise codes of conduct.

Clarifying the scope of the unregulated markets and activities to be potentially covered by recognised codes

We recognise that the current consultation gives several indications of the intended market or activity scope². However, we would welcome a clear list of unregulated markets and activities

² The consultation mentions:

- benchmarks,
- the Perimeter guidance (PERG) in the FCA Handbook,
- the fixed income, currency and commodity markets covered by FEMR,
- wholesale OTC trading in cash foreign exchange and physical commodity trading as an example of unregulated market linked to regulated derivatives markets,
- the Global Foreign Exchange Committee’s (GFXC) FX Global code,
- the FICC (Fixed Income, Currency and Commodity) Market Standards Board (FMSB), which currently proposes several standards: New Issue Process Standard for the Fixed Income markets, The Binary Options standard for the Commodities markets, Reference Price Transactions for the Fixed Income Markets standard, Risk Management Transactions for New Issuance Standard, Monitoring of written electronic communications Statement of Good Practice for FICC Market Participants, Front Office Supervision Statement of Good Practice

the FCA is interested in. We anticipate that codes governing several instruments and markets may be potential candidates for recognition (eg, foreign exchange, bullion and money markets, as well as repos and securities lending), but would welcome any further examples the FCA envisages would be caught under the “unregulated” activity.

Focusing on cross-border regulatory cooperation

Cross-border regulatory cooperation is of particular importance for OTC derivatives, the most ‘global’ of financial instruments. An ill-considered cross-border impact of rules, guidance or codes 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. Such issues should be avoided in the context of codes of conducts for unregulated markets (eg, cash foreign exchange and physical commodity trading) that are closely linked to regulated derivatives markets.

In particular, we would welcome a clarification on whether:

- Foreign branches of UK firms should observe the UK recognised codes of conduct (potentially facing different standards than their local non-UK competitors); and
- Whether the FCA will consider recognising codes written in different jurisdictions and consider if they are appropriate for the UK market specificities.

Supervision and enforcement

Recognised codes

We recognise the intent of the FCA to say that “Our recognition would not change the voluntary nature of any industry code. Firms are free to develop or follow alternative codes or standards, or develop their own approaches, where there are currently no binding rules.” (4.7) and (3.27) “[...] we believe it appropriate that we [the FCA do] not supervise firms or individuals directly against any market codes in unregulated markets.”

We are concerned, however, that certain sections of the proposal, as currently drafted, may appear to contradict the intent mentioned above. For instance, 1.10 saying that one of the aims of the proposals is to “enhance [the FCA] ability to act against [...] misconduct by authorised firms and individuals” or 3.31 stating that the FCA “may not take action for every breach of the individual code rules, and a technical failure to follow a market code may not itself be a breach of proper standards.”

This may result in recognised codes of conduct being perceived as having quasi-regulatory status. This may disincentivise firms to submit codes for recognition, or else draft defensive codes (in light of the possibility that they may be submitted for recognition) that are not as useful for market participants as they otherwise could be.

for FICC Market Participants, Statement of Good Practice setting out Core Principles relevant to conduct training, Surveillance in Foreign Exchange Markets.

To help mitigate this, we would suggest that the FCA explicitly states that:

- The FCA does not intend to enhance its enforcement powers via recognised codes.
- The FCA will not directly enforce (and supervise) adherence to recognised industry codes (only indirectly as one of a possible ways to meet the SM&CR conduct requirements).
- The SM&CR requires individuals to observe ‘proper *standards of market conduct*’ in regulated and unregulated activities.
- One way (of many) to show compliance with ‘*proper standards of market conduct*’ is to comply with (the rules of) ‘*a recognised code*’ of conduct.
- However, there may be different ways of complying with the ‘proper standards of market conduct’, other than the ways described in the ‘recognised code’.
- Therefore if there is a breach of the code (or nonadherence to the code), it does not necessarily (or automatically) mean that ‘proper standards’ are not observed (as required under SM&CR). This is because the standards may be observed in a different way than the one included in the code.
- And therefore compliance with recognised codes:
 - remains truly voluntary in practice,
 - and is not the only (acceptable) way to observe ‘proper standards of market conduct’ and to demonstrate compliance with the SMCR in unregulated markets.’

Unrecognised codes

The FCA states in its proposal 4.14 and 4.15 that it may still use an unrecognised code to inform the FCA views of a way to observe a proper standard and if an enforcement action should be taken. In this context, it is important to highlight that codes may be unrecognised for different reasons. For example, a code may be rejected because the FCA fundamentally disagrees with a standard of conduct it includes or a code may be rejected because it has fallen foul of a procedural or administrative criteria such as the code has not been sufficiently consulted upon. The FCA may want to publicly communicate its reasons for rejecting a code, which would allow the industry to form a judgement on the appropriateness of continuing to adhere to such a code.

Surveillance

We would welcome a clarification that firms and individuals should take only reasonable steps to ensure compliance with a recognised code they have chosen to adhere to. If automated surveillance of compliance and reporting of breaches were required (similar to the Market Abuse Regulation requirements for suspicious transaction and order reporting – which in practice may often require surveillance systems that are automatic, burdensome and costly) it could disincentivise adherence to recognised codes.

Competing codes

In terms of competing codes, it may be preferable that one of the codes is recognised rather than none of the codes is.

Costs

In order to alleviate significant implementation costs of a recognised code of conduct (that may be similar to costs of implementing a regulation), we would recommend allowing enough time for implementation and reasonable approach to interpretation where a code includes a general or principles based language like ‘best effort’ or ‘as soon as practicable’ or ‘where appropriate.’

Q4: Do you agree with the proposed changes to the FCA Handbook designed to give effect to our proposals? If not, please provide your reasons.

We believe that these modifications would need to be reconsidered, preferably after further clarifications on the scope, character and details of the proposed changes, as discussed in our answers to Questions 1-6.

Process for seeking ‘recognition’ of industry codes

Q5: Do you agree with our proposed process for recognising certain industry codes? If not, how should we amend it?

We generally agree with the FCA proposals but would highlight several issues.

The FCA engagement in drafting

While the codes should be drafted by the industry and be voluntary to adhere, an arbiter role may need to be considered for the competent authority in case of diverging views among market participants. A drafting process oversight role might also be taken into account.

Interim review

A reasonable engagement of the competent authority in reviewing the draft would be welcomed. It could consist in carrying out one or two interim assessments or a review of an almost final draft, with an official feedback statement publicly available.

Time limit on recognition and withdrawal of recognition

It would be important to allow more time than three years for a code of conduct to be valid, given that it can take several years and significant resources to develop and implement it. Any extension of the recognition should be ensured before the expiry of the validity period. Alternatively, and preferably, a recognised code should be valid for an unlimited period of time. It is important, however, to keep the code up to date. This should be allowed without challenging its continuity, but at the same time with a sufficient notice for market participants to allow enough time for the implementation of changes. It should also be possible to withdraw the recognition if needed, again with a sufficient notice and a phased in approach.

Unrecognised Codes

Where the FCA has considered and ultimately decided not to recognise a code, it should issue a formal statement notifying the market, including the reasons for rejection, as explained in Q3.

Q6: Do you agree with the criteria proposed for deciding which codes to recognise? If not, what additional or alternative criteria should we consider?

We generally agree with the FCA proposals. We agree with the FCA that a genuinely public consultation allowing all interested stakeholders to respond should be ensured. In particular we believe it should include a feedback statement (eg, explaining why certain proposals were considered and rejected). With regard to situations where a code covers both regulated and unregulated markets, it should be specified which sections of the code are recognised for unregulated markets. Furthermore, the FCA should provide prior notice to the market of codes it is considering for recognition, thus allowing market participants to object if necessary. This would provide a degree of additional governance to ensure that authors (eg, standard setting entities, trade associations or individual firms) submit codes for recognition appropriately taking into account the interest of the broader market.

Questions for Discussion

Q7: Do you believe the FCA should consider extending the application of Principle for Businesses 5 (A firm must observe proper standards of market conduct) to unregulated as well as regulated activities? If not, please state why.

While the extension of the application of Principle 5 to unregulated markets is worth considering, the FCA's prior successes with enforcement cases under other principles that already cover unregulated markets, as was demonstrated with the LIBOR and FX scandals, should be taken into account. We would also suggest the FCA considers how such enforcement powers under Principle 5 may interact with the FCA's competition powers that can already be used to take action in unregulated markets.

Q8: What benefits and challenges do you believe this would pose to FCA authorised firms, the FCA or financial markets more generally.

Such an extension could enhance higher standards of market conduct in all activity performed by regulated firms, as it might encourage firms to scrutinise their conduct in unregulated activity to a similar standard as for regulated activity.

While an extension may support a level playing field in authorised firms between their regulated and unregulated activity, the extension could result in authorised firms being held to higher standards for their unregulated activity compared to unauthorised firms conducting the same unregulated activity. This may result in a possible competitive disadvantage for authorised firms.