

Annual Report

2013/14



FCA

Markets
Practitioner Panel

The background is a solid purple color. In the upper half, there are several white, wavy, overlapping lines that create a sense of motion and depth. Scattered throughout the purple area are numerous small, out-of-focus white circles of varying sizes, resembling bokeh or light particles.

Chairman's foreword

I am pleased to have led the successful establishment of the new FCA Markets Practitioner Panel for the FCA in its first year of operation. The Panel was created as a safeguard for proper consideration of wholesale as well as retail issues within the new regulatory framework. I have been grateful to all the Panel members who, as senior industry representatives, have agreed to volunteer their time to contribute to these important regulatory debates.

The FCA Board and Executive have engaged actively with our group throughout the year and fully acknowledge the importance of London's wholesale markets for the UK economy. Much of our work has been focused on the FCA's Markets Division and we have aimed for open and constructive debates about the challenges the FCA faces in this important area of responsibility.

A key theme of our work in the last year has been the importance of wholesale markets to the UK, and the requirements on the regulator to look beyond the UK to engage in the wider international discussion about regulatory development. With large amounts of the UK regime being derived from EU legislation, the FCA with the Panel's support must be successful in influencing its counterparts in the EU, and globally to take a proportionate approach to ensuring markets function well.

In the coming year, the Panel will be turning its attention to two major projects for the regulator – first, the creation of the technical detail that will underpin the new MiFID 2 regime; and second, the FCA's first competition study into the wholesale markets. The Panel hopes it can add value and offer strategic advice and support, to obtain the best outcomes on these work-streams for the markets and their customers. As we have done this year, in the coming year we will be encouraging the FCA to consider the wholesale markets located in the City of London as an asset to the UK, which requires strong but proportionate oversight and supervision.

Paul Swann
Chairman, FCA Markets Practitioner Panel

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Introduction

This annual report is for the Markets Practitioner Panel (the Panel), which is a statutory Panel for the Financial Conduct Authority (FCA). The Financial Services Act 2012 required the Panel to be established to represent the interests of practitioners who are likely to be affected by the exercise of the FCA's functions relating to markets. We have held four formal meetings since the Panel's inception in April 2013, and have arranged a number of working groups to continue our discussions on markets regulation.

The Panel provides senior level industry input to the FCA on wholesale market issues, with membership selected to reflect the major sectors of the UK's wholesale and securities markets. It focuses on important strategic regulatory issues and seeks to complement the work of trade associations, with regular liaison with the main trade associations to help ensure a coordinated view from the industry to the regulator.

Early on in its development, the Panel agreed some key themes for its approach which are used to structure this report as follows:

Providing input to the FCA approach to wholesale and markets supervision;

Supporting a strategic approach from the FCA on international engagement to ensure that markets function well; and

Identifying risks in the markets.

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PROVIDING INPUT TO THE FCA APPROACH TO WHOLESAL AND MARKETS SUPERVISION

The FCA's strategic objective is to ensure that financial markets function well, with operational objectives to secure an appropriate degree of protection for consumers; to protect and enhance the integrity of the UK financial system; and to promote effective competition in the interests of consumers.

In the FCA's first year of operation, the Panel worked to support the development of a regulatory and supervisory approach that was consistent with the wider vision of the organisation, and yet was also appropriate and effective for the wholesale markets

Wholesale and markets supervision

The FCA approach to conduct supervision is based on forward looking and judgement based regulation. It has certain statutory responsibilities, including the need to consider all users of financial services, large and small (including corporates) as 'consumers' under the Financial Services and Markets Act 2000.

As the FCA took over from the FSA in April 2013, there was some nervousness amongst practitioners about how the conduct agenda and wider definition of consumers would be applied to professional and sophisticated market counterparties. We discussed the need to agree different concepts of 'harm' and 'detriment' for the wholesale markets, and supported the FCA's planned proportionate approach, with a gradual shift from retail to wholesale

styled supervision as appropriate for the different firms and activities.

We welcomed the Memorandum of Understanding for coordination between the FCA, Prudential Regulation Authority (PRA) and Bank of England in their oversight of different parts of the markets. We registered some concern as to how this will work in the fast-moving markets space, and so will be interested to see how this develops going forward.

The FCA has a greater role in the supervision of market infrastructure than the FSA had previously. The Panel urged the regulator to work particularly closely with these types of firms, as they themselves can assist the FCA in overseeing the markets. Exchanges, clearing providers and settlement systems pose natural challenges for the FCA objectives, given their importance in providing market stability, while their small number invites careful consideration and review of their competitive position. We were keen to see the FCA establish a clear regime and working relationship with its recognised bodies.

Markets Division – measuring performance.

The FCA Markets Division delivers the FCA's responsibilities for the supervision of market infrastructures, the formulation and negotiation of markets policy, the identification and investigation of market abuse, the functions of the UK Listing Authority (UKLA) and the activities of the Client Assets Unit. Its focus is on ensuring efficient, stable, fair, clean and resilient markets where client money and assets are protected and high standards of conduct are adhered to by all participants.

We were pleased to review plans for success measures for the FCA's Markets Division this year and encouraged the use of 'market cleanliness' statistics to monitor how the FCA's market monitoring and enforcement deterrence was working.

We suggested that the FCA could also look at other metrics that ensure it is considering the nurturing of thriving, efficient and effective markets that work well for consumers, which can be linked directly back to the FCA's statutory objective to make markets work well for consumers. For example, the Panel noted that consumers benefit from deep and liquid markets in commonly traded financial instruments and yet FCA policy could have an impact on the volume of trading and liquidity. Although correlations can be difficult to draw, we recommended that the FCA should monitor the trends and look at

where regulation may have added to or subtracted from the trend.

Enforcement Effectiveness

The FCA's Enforcement and Financial Crime Division conducts forensic investigations into suspected misconduct and compliance failures, and works closely with the wider FCA and other agencies to ensure that there is an effective and coordinated approach to combating financial crime.

The Panel is fully supportive of the FCA's efforts to root out poor practice, market abuse and manipulation and breaches of the FCA rules that may harm the clean working or reputation of the markets. We suggested the FCA should focus on deliberate breaches of the rulebook, rather than public censure for accidental and technical breaches. This means that FCA resources should be devoted to clarifying and simplifying rules to prevent technical breaches, as well as concentrating on catching those who deliberately breach the rules. This is particularly the case for smaller firms, where greater transparency and explanation of regulatory requirements was often needed, to assist those without large compliance teams. The Panel also emphasised the desire from exchanges and other infrastructure to work with the regulator as their interests in clean markets are aligned.



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SUPPORTING A
STRATEGIC APPROACH
FROM THE FCA ON
INTERNATIONAL
ENGAGEMENT TO
ENSURE THAT MARKETS
FUNCTION WELL

The FCA is required to implement, supervise and enforce European Union and international standards and regulations in the UK. To support this, it also contributes to international debates and policy-making processes to enable its key aims, of protecting the consumer and maintaining market integrity, to be embedded in international regulation.

In the wholesale markets, unlike retail markets, a large amount of business is conducted crossborder and involves firms with international scope and activities. We know that the FCA leads many international discussions on regulation, given its role overseeing London's markets. The Panel has aimed both to support this and encourage further strategic thinking about how the FCA can achieve the right outcomes for global markets located in the UK in the international context.

International context for FCA markets work

The FCA controls the UK wholesale markets where participants are either themselves operating across a number of different jurisdictions, or at least their counterparties and investors are based all around the world, with the financial instruments referencing securities, currencies and commodities globally. The FCA therefore enforces rules set by the European Union and the European Supervisory Authorities (ESAs), including the European Securities and Markets Authority, ESMA.

The Panel has been keen to ensure that the FCA takes a strategic and planned approach to its engagement and negotiations on EU and international regulatory requirements. It is critical for the firms that the Panel represents that the UK can maintain its leading position in global markets. This is difficult in cross border regulatory and supervisory developments when the FCA has to influence and agree common standards being developed at European level or by other supra-national agencies.

We have expressed some concern that the FCA has developed a structure to spread responsibility for international work across a number of Divisions to ensure appropriate knowledge and expertise. We have been reassured that coordination is achieved within the FCA, and it is seen as a well-resourced thought-leader among European member states. It is vital for the FCA to continue its commitment to international negotiations and to consider new strategies to maintain that position in the light of recent European Parliamentary elections and a renewed European Commission during 2014. The FCA must continue to maximise its role and ensure it takes every opportunity to influence outcomes in international negotiations as these will impact directly on the workings of markets located in the UK.

UK Growth agenda and competitiveness

As well as its strategic and operational objectives, the FCA has a number of principles of good regulation set out in the Financial Services and Markets Act. One of these is 'the desirability of sustainable growth in the economy of the United Kingdom in the medium or long term'.

Although the FCA no longer has the FSA's statutory requirement to have regard to the competitive position of the UK, we have been keen to encourage the FCA to consider that its statutory principle on the desirability of growth in the UK economy should be clearly applied when considering cost benefit analysis for new policies or projects.

The Panel has been pleased that the FCA will consider some aspects of the competitiveness of UK markets through applying a robust, well designed and proportionate regulatory regime to all aspects of its work. For example, in discussions on 'MiFID 2' (Markets in Financial Instruments Directive) data reporting, we stressed that, although we supported increasing regulator access, thought needs to be given on how duplication can be avoided and how intelligent, efficient solutions to reporting can be implemented. Also, the FCA announced work on investigating the potential risks and conflicts in asset managers' and brokers' use of dealing commission which was welcomed by the Panel. Nevertheless, we have been concerned that the UK was developing standards without in principle buy in from contemporaries at a global level. The nature of asset management and trade execution services is such that by making arrangements more expensive or burdensome in the UK, activity may migrate to locations with different regulatory or supervisory standards. This would be a loss to UK investors and the UK economy without any tangible improvement in supervisory or regulatory outcomes.

MiFID 2

The primary legislation was passed in Europe for MiFID 2 (Markets in Financial Instruments Directive) at the end of 2013, and follow on work has therefore started on ESMA technical standards and the domestic implementation. MiFID 2 builds on the previous changes for European Equity markets changes and international agreements, and extend the reforms across both equity and non-equity markets. The reforms include encouraging greater pre- and post-trade transparency for equities and non-equities, creating new forms of regulated trading venues (eg the OTF) and limiting the use of waivers and the volume of trading in 'dark pools'.

Panel members discussed with the FCA a key challenge of MiFID 2 as being the provision of data and the cost and use of the data. With firms already reporting transaction data under older requirements, and with recent changes to reporting in the derivatives market, the Panel was keen to stress that these should be brought together wherever possible to avoid duplication. We urged the FCA to consider bold and innovative solutions to the data challenge. If this challenge was not met, we saw the risks of inefficiencies arising, duplication and poor quality data that is not useable. The ultimate requirements must seek to work for both UK and EU-wide trading, with sharing of data between the FCA (and other market supervisors where appropriate) and ESMA, and by utilising existing infrastructure and

systems where possible. For example, we suggested that exchanges and clearing houses could handle some of the submissions for their users, and possibly the FCA's own transaction recording system (Zen) could be used to meet MiFID 2 requirements on the regulator.

The Panel also raised questions about the impact of MiFID 2 requirements on the liquidity of trading in certain securities and financial instruments. There are risks that, if the requirements are not calibrated properly liquidity, and the volume of trading more generally, in smaller and less traded securities and derivatives may be negatively impacted. We encouraged the FCA to look at international experience and for the FCA and ESMA to conduct thorough cost benefit analysis on all of their proposed requirements before action is taken.

The Panel has also requested that the FCA allows sufficient time for firms to implement the requirements – many of which are complex, time-consuming to implement and expensive, especially in terms of creating new systems and changing business models and operations. It is our hope that the FCA can provide an orderly plan and transition for firms into the new regime in 2016/17.

Dealing commission

During 2013, the FCA consulted on whether reforms were needed in the longer term to address perceived shortcomings in the use of dealing commission regime. In March 2014, the FCA published its policy statement which reinforced the previous rules and provided greater clarity on what investment managers can pay for using client dealing commission. It states that investment managers should only use client dealing commission to pay for substantive research or costs related to executing trades.

The Panel was supportive of the FCA's investigation into the use of dealing commission and the good level of industry engagement. We urged the FCA to align any changes with the development of MiFID 2 requirements.

We registered concern about any proposals to ban commission completely, and suggested that unbundling might not stand up to cost benefit analysis. For example, we highlighted that an unbundled service may lead to an under-provision of research in the market, if consumers are not willing to pay and will concentrate on simply the fund management charges. This would lead to a reduction in research being undertaken, particularly on smaller cap and less well-known stocks. This in turn could reduce the liquidity in these stocks, and remove both funding from small companies and the ability of investors to access growth stocks. The Panel also raised

concerns about potential changes to the competitive dynamics and economics of the asset management industry due to differing impacts on firms according to size. Smaller firms, who have to rely on external research from brokers, may become unable to compete, to the detriment of consumer choice. We therefore urged the FCA to consider potential impacts, and explore other options for addressing perceived harm and consumer detriment, including stronger supervision and mandating greater clarity over investor charges.

We also expressed concern about press coverage about the FCA's proposals, and the emphasis on corporate access requirements. We felt the FCA should have aimed for more balanced coverage, and clarified that corporate access can be a valid practice. It is important from a corporate stewardship perspective, and from the obligation that asset managers have to those whose money they are investing, that managers make efforts to properly understand the businesses in which they are investing their clients' money.

We were pleased that the FCA decided to issue the policy statement which clarifies certain ambiguities and sets out uses of commission which are not acceptable to the regulator.

Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards (PCBS) was established to review standards in banking and published its report 'Changing Banking for Good' in June 2013. The report made a large number of recommendations, many of which were to be carried out by the FCA. The FCA published its initial response to the PCBS report in October 2013, which set out next steps for its implementation of the recommendations.

We highlighted the possibility of unintended consequences of a wider application of the PCBS changes by the FCA to non-bank financial services providers, such as those represented on the Panel. There was recognition that generally senior management accountability is a good thing but we stressed that the proposals must be carefully targeted to tackle the sectoral risks that emerged during the financial crisis, as well as those that are likely to arise going forward. We encouraged a proportionate approach to implementation of the recommendations, which could otherwise create undue burden and impact on innovation and provision of good services to customers.

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IDENTIFYING RISKS IN THE MARKETS

The FCA's stated aim in its supervision is to use forward-looking and judgement-based regulation, with a view to understanding firms' business models and future strategies, and to intervene if it sees unacceptable risks to the fair treatment of customers or the integrity of the market.

The Panel has a role to provide input to the FCA's plans for how it will address specific risks, market stability concerns or wider problems with competition issues in the markets.

Perimeter risks

As part of the FCA's statutory responsibilities, it must monitor the new and innovative firms or markets that are emerging and consider whether they fall in or outside of the FCA's regulatory perimeter.

During the year, the Panel looked at the raising of funds by the sale of stakes in new start-up businesses on crowd-funding platforms, which were due to be regulated by the FCA from 1 April 2014 as part of its new remit over the consumer credit sector. We suggested that this area will need a careful and proportionate approach from the FCA, as although there is a relatively high failure rate, the new market is innovative and provides real consumer choice to meet demand for high-yield investment opportunities, and provides much needed funding to SME businesses, which in turn benefits the broader UK economy.

We also suggested that the FCA should monitor the rise of 'crypto-currencies' such as Bitcoin, as an investment asset. This market is currently unregulated, although many investors are using Bitcoin as such an asset. The rise of infrastructure to facilitate Bitcoin trading, including exchanges, also poses stability risks to the Bitcoin market. We felt this was a valid area for exploration by the FCA to see where risks lie for consumers and where its existing powers could apply.

Market abuse work

The FCA's statutory objectives give clear responsibility for reducing instances of market abuse and as a result protect the integrity of the financial markets and increase investor confidence.

We encouraged the FCA to be clear and proportionate about the market abuse requirements, by dedicating more resources to tackling serious and intentional breaches, rather than more minor and technical failings. It was appreciated that often intentional cases were harder to detect and more difficult and time consuming to prosecute, but this is where the focus needed to be to protect the integrity of the markets.

We questioned whether the FCA investigating teams focus sufficient attention across all of the different markets. There seem to have been more market abuse cases pursued in equities markets compared to other areas. Although cleanliness is important for equities, the FCA needs to be careful to apply equal attention to all markets.

FCA Business plan and competition in the markets space

The FCA Business Plan for 2014/15 was published on 31 March 2014 and sets out the activities that the FCA intends to carry out in the year to protect consumers, enhance market integrity and promote competition.

Panel discussions on the FCA Business Plan focused on the scope of activities for the FCA's Markets Division during 2014-15. We have been supportive of proposed plans to tackle the large amount of reform that is currently going on in the markets. Legislation from the EU continues to dominate the policy agenda and we continue to emphasise the importance of FCA contributions to the international debates.

One major project for the forthcoming year that the Markets Division will work with Competition colleagues on is the Wholesale Strategic Review and Market Study. We felt it was important for the FCA to explore with the industry where potential competition issues may exist, and which caused greatest concern or could be most easily remedied, before a full market study is started. The FCA would need to define the types of detriment it needs to tackle, and be clear about the types of intervention in the market the FCA considers to be appropriate. We appreciate the FCA's basic proposition that competition issues in the wholesale market may ultimately impact on competition, prices and service in the retail market or to investment returns for retail investors. However, modern wholesale markets are particularly complicated and often interconnected with other markets, and therefore we urged caution and encouraged the FCA to delve deep to understand the full reason why arrangements appear as they do.

We also highlighted the difficulty of defining the boundaries of the market to be studied. With many wholesale markets operating for the benefit of and with input from non-UK participants, and with London competing against other financial centres, the market could potentially be drawn globally. We pointed out that this will naturally pose challenges for the FCA, should it choose to impose any structural remedies to address discovered issues.

Client Asset and Money Regime (CASS) review

The FCA undertook a review of the Client Asset and Money Regime (CASS), following the lessons learned from the collapse of Lehman Brothers, as published in CP13/15.

The Panel discussed the proposals around ensuring faster pay out of client money, better record keeping, greater disclosure and ensuring that clients understand how and when their money and assets are protected. We felt that the proposals were sensible and addressed many of the issues identified in recent insolvency cases. Our view was that there was a real risk for consumers if the CASS rules were not robust and well designed, or were not properly complied with.

We highlighted the difficulties of achieving a balance between insolvency practitioners distributing assets promptly after insolvency is declared and ensuring clients receive maximum return of their funds, with enough assets for equal return and treatment of all classes of clients. We welcomed the fact that the FCA was working closely with HM Treasury, given that the regime interacts with the Special Administration Regime created by Government legislation. However, there was a feeling that more work is needed to improve the speed of return and ensure the outcomes for clients are predictable. The CASS regime must remain the important kitemark of protection for investors and participants in UK market, and we look forward to seeing continuing FCA attention on this area.

Members of FCA Markets Practitioner Panel

1 April 2013 – 31 March 2014

Paul Swann

(Chairman)

President and Managing Director, ICE
Clear Europe

Simon Bragg

CEO and Chairman of Corporate
Finance, Oriel Securities Limited
(Member from 1.5.13)

Scott Cowling

Managing Director and Head of EMEA
Equity Trade, Blackrock Investment
Management (UK) Limited
(Member from 1.5.13)

Mark Harding

Group General Counsel, Barclays Group
(Member to 31.12.13)

John Hitchins

Global Chief Accountant and Financial
Services Partner, PwC

Mark Ibbotson

Group Chief Executive Officer, G. H.
Financials

Alexander Justham

CEO, London Stock Exchange plc

Jim Kandunias

COO, Immersion Capital

Abdallah Nauphal

CEO, Insight Investment Management
(Member from 1.5.13)

Julian Palfreyman

CEO, Winterflood Securities
(Member from 1.5.13)

James Palmer

Partner, Herbert Smith Freehills
(Chairman, Listing Authority Advisory
Panel)

Daniel Pinto

CEO Corporate & Investment Bank and
CEO EMEA, JP Morgan Securities Plc
(Member from 1.5.13)

Alan Trotter

Finance Director, Alliance Trust Plc
(Member from 1.5.13)

John Trundle

CEO, Euroclear UK and Ireland
(Member from 1.5.13)



FCA Markets Practitioner Panel

25 The North Colonnade
Canary Wharf
London E14 5HS
Tel: +44(0)20 7066 1000
Email: MPP@fca.org.uk

FCA

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