KEY POINTS

- The FICC Markets Standards Board (FMSB) periodically issues standards and guidance agreed by its members. It has recently released a Statement of Good Practice for primary dealers in government bonds.
- The potential conflicts of interest in the primary market for government bonds are numerous.
- If primary dealers collude in market abuse, there are a number of possible claims available for investor clients under English law.
- In relation to other kinds of improper market conduct, FMSB standards, depending on how they are adopted, may come to form the basis of claims by investor clients.
- But the recent guidance for primary dealers is unlikely, on its own, to give rise to private law claims.

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The scope of English law claims against primary dealers

In this article the authors look at the primary market guidance issued by the FICC Markets Standards Board (FMSB) in the context of the market for government bonds and consider the potential relationship between FMSB guidance and possible claims in English law arising from market abuse.

THE FMSB

The FICC Markets Standards Board (FMSB) came into being as a result of the Fair and Effective Markets Review, which considered standards and behaviour in the fixed income, currencies and commodities (FICC) markets and in 2015 recommended the creation of a market standards board, to be made up of senior personnel drawn from major market participants and market users. The FMSB counts among its members most of the major investment banks who participate in the gilts market and the eurozone government bond markets.

Promulgation of mutually agreed market standards was said by the then governor of the Bank of England, Mark Carney, to be a crucial element of the authorities' efforts to reverse "a tide of ethical drift". To that end the FMSB periodically issues documents in two categories: "Standards"; and "Statements of Good Practice".

Standards and Statements of Good Practice are not regulation; and they are expressly said by the FMSB not to impose legal or regulatory obligations. However, because market participants, users and regulators can comment on their drafting they are intended to represent authoritative statements of proper practice.

There is a distinction between a Standard and a Statement of Good Practice. All members of the FMSB are expected to adhere to the Standards relevant to them, and to restate their commitment to doing so each year by means of a formal Statement of Commitment. The FMSB publishes annually the "adherence status" of all of its members.

As for Statements of Good Practice, the FMSB describes these as reflecting its view of what constitutes good or best practice. It says that its members are expected to consider their own practices in the light of any relevant Statement of Good Practice and make any changes that they deem to be appropriate.

On 14 July 2020 the FMSB published the final version of its *Statement of Good Practice for Participation in Sovereign and Supranational Auctions in Fixed Incomes Markets* (primary market guidance) addressed to primary dealers and investors participating in auctions in government bonds.

In this article we look at the primary market guidance in the context of the market for government bonds and consider the potential relationship between FMSB standards and possible claims in English law arising from market abuse.

THE PRIMARY MARKET

The primary market for government bonds has some obvious special factors. The issuer controls the structure of the market and decides who may participate. As government, the issuer is also, ultimately, the regulatory authority. And the issuer's overriding aim is to ensure that the primary market works to allow it to sell all the bonds it needs to, as often as it chooses, with as little disturbance and cost as possible. That might be a statement of the obvious: but it serves as a reminder that some of the imbalances and sources of conflict present in the primary market are there by design, because they serve that overriding aim of the issuer.

Of central importance is the network of primary dealers who are appointed by the issuer, pursuant to a primary dealer agreement, to buy, promote and distribute government bonds. Issuers rely on primary dealers to provide a ready market for auctions of bonds, maintain liquidity in the market, and market bonds to investors. A typical primary dealer agreement will require primary dealers:

- to provide a two-way price in each bond to all investors, throughout every working day;
- to achieve a certain minimum percentage of the turnover in the secondary market;
- to bid in auctions, bidding for and buying a certain minimum percentage (over time) of the bonds; and
- to consult with the issuer and provide it with market information.

In return, primary dealers are given certain privileges. They have access to privileged information, because bids in auctions can only be made through them, and because of their privileged position as consultees of the issuer. They may be given a non-competitive allocation of bonds at auction; or have exclusive access to inter-dealer markets and to repo facilities at the central bank.

For example, primary dealers in UK gilts, known as gilt-edged market makers (GEMMs) are required by the issuer, the Debt Management Office (DMO) to provide a continuous pricing service and liquidity to all market participants by committing to make effective two way prices in every bond for which they are a market maker. And they are expected to maintain a minimum 2.5% market share on a rolling three-month average.

As for primary issuance, GEMMs are required to play an active role in the marketing of government bonds and to participate in regular consultation meetings with the DMO, as well as playing an active role in the auction itself. They are expected to buy at least 2.5% of the volume of bonds issued, on a rolling three-month average, and to make total bids for 5%. While they are the only persons allowed to bid in the auction, they may charge no fee for placing bids on behalf of their customers.

In return, the privileges afforded to GEMMs include a share of a non-competitive allowance of bonds at each auction, of 10% of the total amount of bonds on offer. In the secondary market, they have exclusive trading and viewing access to the services of inter-dealer brokers, where they can trade with other GEMMs anonymously, and they can access the DMO's standing repo facility, allowing them to borrow bonds to cover a short position. Further, the DMO will only trade in the secondary market with GEMMs.

And as the only persons permitted to bid in auctions, GEMMs have a privileged picture of the demand for each auction. They are expected to take advantage of that, as is expressly acknowledged in the DMO's handbook:

> "… all other market participants wishing to bid at a gilt auction must route their order through a GEMM which, whilst not permitted to charge a fee for this service, *may use the information content of that bid to its own benefit*." (Our emphasis).

Participation in the auctions themselves is not a profitable activity for primary dealers. But there are plenty of reasons why a primary dealer would wish to maintain that status. As is clear from the above, the only way to be a central player in the gilts market is by being a GEMM, with privileged access to the inter-dealer market. Further, a prominent position in the government bond market may be considered to be a political necessity for some financial institutions; or at least brings with it other market opportunities, by reason of the status it affords and by access to the right clients. And in some markets (but not typically in the gilts market) a bank with a prominent share of the auction market is more likely to have the opportunity to participate in another form of issuance, syndication.

POTENTIAL CONFLICTS

So in most auction scenarios, primary dealers will have had prior access to non-public information from the issuer; will have privileged information about activity on the secondary market; and will have privileged information about investor interest in the auction, including the identities and volume of some bidders.

They will be bidding in the auction for themselves and on behalf of clients. Further, their own bids may be occasioned by a particular view of the market, or the need to hedge or cover a position in the secondary market; but in some circumstances their bids may not be motivated by a specific dealing position, but rather arise from an institutional requirement to maintain a high profile in government bond auctions, or simply to maintain primary dealer status.

Further, even when not otherwise intending to bid in an auction, primary dealers may have a significant interest in the price outcome. They may have an existing position in the issue bond or a closely comparable one; or they may have entered into a reference price transaction (RPT) with a customer. In one form of RPT, for example, a dealer guarantees to sell bonds in the secondary market to a customer at a price fixed by reference to the auction price, say at a spread from the non-competitive auction price.

The potential conflicts are numerous. In the primary market guidance, the FMSB identifies the following competing interests of primary dealers at auction:

(a) to meet their obligations to the issuer under their primary dealer agreement;
(b) to secure credit with the issuer for future issues through other mechanisms (eg syndications);
(c) to help investor clients purchase bonds in the auction;
(d) to purchase bonds on their own account;
(e) to provide secondary market liquidity in and around the time of the auction;
(f) their own commercial objectives to maximise performance of their business to generate revenue.

And the FMSB gives examples of how these interests may conflict. A primary dealer, knowing the price at which its clients are bidding, may want to bid higher to ensure its orders are filled ahead of its clients.

The desire to keep up its participation statistics may provide a primary dealer with an incentive to push its clients into bidding at auction, rather than buying a more suitable bond at a guaranteed price in the secondary market.

If a primary dealer has entered into an RPT, or has another secondary market position that will depend on the outcome of the auction, it may have an incentive to use its privileged position in the auction to influence the auction price, for example by making higher bids than it otherwise would.

And for similar reasons a primary dealer might have the means and incentive to influence the price of an auction by activity in the secondary market, in the same or a comparable bond, around the time of the auction.

THE FMSB RECOMMENDATIONS

The primary market guidance sets out eight "Good Practice Statements", which can be paraphrased as follows.

- Primary dealers should have in place appropriate measures to identify, manage and mitigate conflicts of interest.
- Primary dealers should ensure their

bidding strategies are never designed for the purpose of improperly influencing or manipulating auction levels (and that they comply with their primary dealer agreement).

- Primary dealers should manage their hedging of auction orders and their secondary market activity so that it is never performed for the purpose of improperly influencing or manipulating auction levels.
- Primary dealers should make information available to their customers about how they participate in auctions, in particular to explain that hedging can take place before, during and after an auction.
- Investors should not participate in auctions for the purpose of improperly influencing the auction results.
- Primary dealers should not disclose information about customer orders within their firms except to those who have a valid reason for receiving such information, or as required by the issuer.
- Primary dealers should consider having policies, procedures and guidance that they deem to be appropriate in relation to their arrangements around auctions in light of these statements.
- Primary dealers should consider having training reasonably designed to ensure that personnel understand and act in accordance with these statements.

The guidance is not particularly prescriptive. The FSMB suggests, for instance, that some conflicts of interest could be mitigated by segregating customer orders in the auction from the primary dealer's own trading desk but acknowledges that in some cases this may not be possible. There is no specific guidance on who, within a primary dealer, might have a "valid reason" for knowing about customers' orders in an auction (possibly because, as noted above, this is information which the primary dealer is expected to use for its own benefit).

Some other conflicts of interest are acknowledged and left to operate. For example, the guidance says that a primary dealers' bidding strategy, in bidding on its own account, may properly serve a variety of competing interests: meeting its obligations under a primary dealer agreement; managing its risk in respect of client orders; and managing its own market positions. The only bidding strategy that is forbidden is the obvious market abuse of seeking improperly to influence auction levels.

THE ROLE OF FMSB STANDARDS

How do the regulators see the Standards and Statements of Good Practice promulgated by the FMSB having effect on the behaviour of market participants? They have identified a number of drivers.

First, because FMSB standards are mutually agreed by senior personnel from the major market participants, this is said to lend them authority and lead to a greater willingness to adopt them among market participants. Further, having a clear, mutual standard gives greater effect to peer pressure.

Second, in the UK the Senior Managers Regime makes named senior individuals within institutions personally accountable for regulatory compliance within their areas. This is said to encourage institutional adoption of good practice and create peer pressure within institutions to observe standards.

Third, the existence of clear and authoritative standards can encourage what Mr Carney termed "buy side pressure". Major market participants can state that they are committed to follow a certain code and expect their market counterparties to do the same (as the Bank of England did with the FX Global Code and the UK Money Market Code).

Another means of enforcing market conduct is by the primary dealer agreement itself, and the power in the authorities to exclude a participant from the primary market. For example, on 3 August 2020, the French debt management office Agence France Tresor (AFT) suspended Morgan Stanley as a primary dealer for a minimum of three months, for trades undertaken on 16 June 2015 by which it manipulated prices in the French government bond market in breach of its obligations as a primary dealer, and for failing to give proper disclosure to investigators. The AFT said that the suspension would be lifted once it was satisfied that Morgan Stanley had taken "remedial measures".

Regulators in the largest markets also rely on the breadth and competitiveness of the market to ensure good market practice. Debt management offices design the primary market to be competitive, with a good number of participants (there are 18 GEMMs in the UK); and the minimum turnover requirements help to ensure that business is reasonably spread among them.

In a competitive market, primary dealers are unlikely to get away consistently with offering bad prices to customers. And attempts at market manipulation by a single dealer are made that much riskier and more expensive. In a liquid market with large volume shared among many active participants, very often it will be too difficult or too costly for one participant acting alone to manipulate the price through market activity. And if it succeeds, very often it will be too obvious, as was the case with Morgan Stanley's activities referred to above. The sources of information for debt management offices are not only the official reports of prices and activities, but also ad hoc communications with their primary dealer network.

It may be that if market abuse takes place, the circumstances (in a market where the primary dealers are by design members of an exclusive club with privileged access to information not shared with their clients) tend to favour collusion between primary dealers.

According to the European Commission, that is what took place in the French and Italian government bond markets between 2007 and 2012. On 31 January 2019 the Commission issued a statement of preliminary findings after an anti-trust investigation, saying that it had formed the view that eight banks active in the markets had taken part in a collusive scheme for trading government bonds and buying them at auction, including by sharing client information and co-ordinating trading strategies.

Feature

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LITIGATION

Four of those banks have been named by the plaintiffs in a class action in the US District Court Southern District of New York, *In Re European Government Bonds Antitrust Litigation* (Case No. 1:19-cv-2601). The lead plaintiffs, all pension funds, allege collusion on the part of the defendant banks in two regards: first, in co-ordinating higher bid prices in primary auctions; second, in agreeing as a cartel to offer wider bid-offer spreads to customers, for a period running from 2007 to 2012.

Little is pleaded as to the detail of how the defendants carried out their activities. The claims rely on and repeat the short preliminary findings of the European Commission's anti-trust investigation. The plaintiffs further plead in support the conditions of the government bond market which lend themselves to collusion. They note that primary dealers have access to non-public information, as well as customer order-flow information, providing unique insights into how products will trade on the secondary market. And they note that banks are also ranked by their participation in primary auctions, and ability to provide liquidity on the secondary market, for which issuers reward them with valuable underwriting and derivatives business.

Further, the plaintiffs place some reliance on market or institutional codes of conduct. They say that the defendants' professed adherence to these codes led them to place confidence in the defendants and made it easier for the conspirators fraudulently to conceal their conduct.

However, the pleaded cause of action does not rely on any such code. It is a straightforward anti-trust claim alleging a conspiracy in breach of s 1 of the Sherman Act.

ENGLISH LAW

If primary dealers were engaged in collusive pricing and co-ordinated trading, at the expense of their investor clients, and the European Commission were to make a finding of anti-competitive behaviour in breach of Art 101 of the EU Treaty, then claimants in the UK would be able to bring a claim for compensation alleging breach of statutory duty (in accordance with the 2014 Anti-trust Damages Directive). For these purposes, we assume that the UK authorities will make no changes to the competition law framework after Brexit, as they have indicated.

As for the position at common law, claimants in the UK would have the further option of a conspiracy claim. If the activities of anti-competitive conspirators directly cause harm to other market participants, such as a customer who suffers loss by dealing at prices that have been fixed by collusion, then those affected should not have the same problems in establishing intention as led to the striking out of conspiracy claims brought alongside competition law claims in *Emerald Supplies Ltd v British Airways plc* [2015] EWCA Civ 1024.

In cases where problematic market conduct falls short of a conspiracy or an anti-competitive cartel, the causes of action are somewhat harder to discern. Might the FMSB's standards play a role in developing privately enforceable standards of market conduct? Conceivably, yes. A promise to observe certain standards of conduct might form part of the contract between investor and primary dealer; or a representation that the primary dealer subscribes to certain standards and has effective systems in place to ensure compliance might form the basis of a misrepresentation claim or a claim in negligent or even fraudulent misstatement.

One can expect many contractual arrangements to include disclaimers limiting the scope for such matters. But if, say, market participants were to follow the path envisaged by Mr Carney, and routinely require each other to commit to a particular FMSB Standard, then the said Standard might be found to be incorporated as a term of their contractual arrangements.

Or if a primary dealer, in its communications with clients, were routinely to make reference to its adherence to the relevant FMSB Standards, or to hold out its adherence as a reason to trade with it, then at some point any disclaimer would probably have to give way to the facts. In years to come, Standards, and even Statements of Good Practice, may come to be seen as constituent parts of a bank's market offer, and may thereby inform privately enforceable standards of market conduct.

That said, while FMSB Standards in general might prove fertile ground for future private claims, the primary market guidance appears a less likely candidate. Members of the FMSB do not make a statement of their commitment to adhere to Statements of Good Practice as they do with Standards. And, as we have seen, this particular Statement of Good Practice contains few clear prescriptions. Perhaps it acts not so much as a source of protection, but rather as a reminder of how much imbalance of information and conflict of interest remains permitted, even necessary, in the primary government bond markets. ■

Further Reading:

- Market manipulation: a wrong without a remedy? (2016) 2 JIBFL 67.
- Rights of last look: a legitimate tool or abuse of the auction process? (2012) 10 JIBFL 608.
- LexisPSL: Procedures relating to the market maker exemption and the authorised primary dealer exemption.