One Size Doesn't Fit All:

WHY FIRMS NEED A TAILORED FIXED INCOME STRATEGY

Nasdaq

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In the wake of updated regulatory standards such as MAR and MiFID II, there is heightened focus by regulators on monitoring of OTC-traded products. The aftershocks of the Financial Crisis (2008), followed by a series of high profile manipulation cases (including LIBOR 2012) reinforced the perception that OTC-traded products had been flying 'under the radar' and were not subject to the same level of scrutiny as other asset classes, and consequently had the potential to bring financial markets into disrepute.

Prior to this shift in regulatory focus, the perception was that Fixed Income and other OTC asset classes were 'professional' markets. Because of this, it was assumed that participants were aware of the risks and that any financial risk or damage was limited to that subset of market participants. However, the Global Financial Crisis and trading scandals made it clear that market abuse in OTC products had the potential to cause significant risk and harm to broader financial markets.

Regulators Turn their Focus to Fixed Income

In the last five years the industry and regulators have pushed for participants to put in place robust and systematic (rather than ad hoc) surveillance systems for OTC asset classes, with a particular focus on Fixed Income.

For example, the Financial Conduct Authority (FCA) 'Market Watch' No. 56 (Sept 2018) focussed on Fixed Income (FI) surveillance and apparent gaps in the methods being used by market participants to effectively monitor asset classes. As part of this notice, the FCA raised explicit concerns about financial institutions' approaches to FI surveillance and what it considered to be the surprisingly low number of suspicious transactions and orders raised for Fixed Income.

In addition, there has been a steady stream of regulatory settlements, lawsuits and criminal proceedings. In the last 18 months alone, the following cases have had visibility:

- JFSA vs. Citi (2019)
- AMF vs. Morgan Stanley (2019)
- CFTC vs. Rivoire (HSBC) (2019)
- European Commission vs. BOA et al. (2019)

More detailed guidelines for acceptable dealer behaviour have also been published in recent years, often as a result of a consultation process between market participants, central banks and regulators (e.g. FX Global Code, UK Money Markets Code).

One Size Does Not Fit All

The increased focus on Fixed Income monitoring over recent years has made it clear that approaches used in Equity and Exchange-traded markets cannot be easily applied.

At the core of this challenge is the fact that Fixed Income markets are decentralised, over-the-counter and opaque, meaning that reliable and harmonised data from participants and the market is not readily available. For all but the most liquid Government and Corporate bonds, reference data as to where the "market" is at any given point in time is patchy, often stale, and derived or evaluated from a group of sources that capture a particular or segmented view of the market. Equally, such is the nature of Fixed Income trading – the very objective of identifying what the 'market' is for particular bonds at a particular time may at best be irrelevant or at worst be misleading.

Adding to the complexity, the market structure is different for Fixed Income. In Exchange-traded markets the participant/bank is typically acting as agent. When trading OTC, the participant is acting as both principal and agent, meaning the data environment must integrate both incoming (D2C) and outgoing (D2D). The challenge is having visualisation, data, and detection models integrated across these two flows.

What to Look For

When looking at the manipulative behaviours that are most common in Fixed Income, in principle, the behaviours and strategies are similar to those in Exchange-traded products (e.g. Equities, Futures). However, due to the unique characteristics of OTC markets, the tactics often differ. For example:

- The FI market is highly concentrated, which makes it more susceptible to collusive behaviour among banks and primary dealers.
- RFQs and various types of client orders are very common in the FI market, which increases the risk of front-running.
- Different FI instruments are highly correlated with each other (currency, maturity, issuer etc.). Spoofing, ramping etc. may involve a combination of different securities or instruments.
- Insider trading is less common because governments rather than companies often publish market-moving information. Instead, other types of market-moving information become vital to monitor (e.g. client orders or setting of benchmarks or fixings).

WHAT IS FRONT-RUNNING?

Front-running is when a trader initiates a trade with knowledge of a larger trade on that same asset that has not yet been been placed, possibly influencing price substantially.

In OTC markets an incoming RFQ message is an expression of an intent to trade and is potentially price sensitive.

Addressing Fixed Income Surveillance

As a result of these unique characteristics, there are several measures that firms should consider when looking to effectively monitor Fixed Income markets. These include:

- Incorporating YTM and DV01 into alerting metrics and visualisations is crucial in normalising bond trading across a range of attributes and identifying anomalies.
- Focusing on a trader's trading behaviour across FI products – utilising metrics such as DV01 to benchmark 'normal' activity so that anomalous trading patterns can then be identified.
- Integrating a mechanism for linking related Fixed Income products across physical/OTC and Exchange-traded markets, as well as integrating a program to identify market abuse or otherwise anomalous trading across those products.
- Integrating both D2C and D2D order flows as well as RFQ flows is important in identifying a key risk in this asset class: front-running.

Conclusion

Recent spikes in volatility have stress-tested surveillance systems across asset classes, reinforcing the need for firms to implement robust and systematic systems for OTC asset classes. As the regulatory pressure in this area continues to build, firms need to evaluate if they are well-positioned to adequately detect manipulation within Fixed Income markets.

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