

October 2017

The Bank Bill Benchmark Rate and closing rates

Guidance note for market participants

This guidance clarifies the FMA's expectations about the trading conduct and controls for firms participating in the trading that sets BKBM and closing rates in the New Zealand market

About FMA guidance

Our guidance:

- explains when and how we will exercise specific powers under legislation
- explains how we interpret the law
- describes the principles underlying our approach
- gives practical examples about how to meet obligations.

Guidance notes: provide guidance on a topic or topic theme. Typically we will seek industry feedback via a public consultation paper, or more targeted consultation before we release a guidance note.

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

You might also like to check the reports and papers on our website. For example, our monitoring reports describe actual practice we are seeing and our comments on this.

Document history

This version was issued in October 2017 and is based on legislation and regulations as at the date of issue.

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Contents

Purpose of this guidance	4
Background	4
Understanding your legal obligations	5
Trade-based market manipulation – clarifying the law	5
Our approach	5
What are we looking for?	6
Price and volume discovery	6
Understanding the legitimate purpose	7
Our expectations	8
What does legitimate trading look like?	9
Demonstrating good conduct	9
Other sources of guidance	10
Glossary	11

Purpose of this guidance

This guidance clarifies our expectations about the trading conduct and controls for firms participating in the trading that sets the Bank Bill Benchmark Rate (BKBM) and closing rates in the New Zealand market. It addresses the risk of trade-based¹ manipulation of BKBM or closing rates. Only a small number of banks² currently trade in the Bank Bills market that is used to calculate BKBM. There are also limited participants in the markets that determine closing rates (Closing Rate Markets).

One of our strategic priorities is capital market growth and integrity. We want to establish conduct expectations in wholesale markets that support growth and integrity. This is a key focus area in our [Annual Corporate Plan 2017/18](#).

We have also published a [resource sheet](#) that has further background for those who need to know what benchmarks are and how they are regulated.

Background

Over recent years many banks have stopped participating in the calculation of certain benchmarks. This may be largely due to a perceived increase in regulatory risk. When fewer banks participate in setting a benchmark there are increased risks the benchmark will not be robust. These issues are particularly acute in New Zealand as we have a small financial market and a small number of banks. One reason for clarifying our expectations around BKBM

and closing-rate trading conduct is to help reduce regulatory uncertainty.

This guidance aims to encourage other institutional participants to return to trading in Bank Bills markets.

We are willing to engage with any such participants to ensure they are clear about our role and expectations.

Although we are aiming to reduce regulatory uncertainty, banks and other market participants retain responsibility for ensuring the trading conduct of their staff is legal and appropriate. Where we identify inappropriate trading conduct, our response will take into account the measures a participant takes to try to ensure good trading conduct, including whether a culture has been developed that focuses on achieving good customer outcomes.

1 Information-based manipulation, which involves the dissemination of false or misleading information, is also illegal, but is not dealt with in this guidance.

2 There are currently six participants in trading that sets BKBM: Bank of New Zealand, ANZ Bank New Zealand Limited, ASB Bank Limited, Westpac New Zealand Limited/Westpac Banking Corporation, Kiwibank and Citibank N.A.

Understanding your legal obligations

New Zealand law supports the fundamental principle that banks may trade to hedge their risk as long as their purpose is to hedge and not to influence the rate set. Although Bank Bills and other products reflected in benchmarks are not listed on any licensed market, which means that the provisions of [Part 5 Subpart 3 \(Market Manipulation\)](#) of the Financial Markets Conduct Act 2013 (FMC Act) don't apply directly to trading in Bank Bills³ or those other products, there are similar anti-manipulation provisions that apply under [Part 2 \(Fair dealing\)](#) of the FMC Act⁴.

Trade-based market manipulation – clarifying the law

The recent high court judgment in *Financial Markets Authority v Warminger*⁵ has helped to clarify that a central element of trade-based market manipulation is that trades have, or are likely to have, the effect of misleading the market. The market is entitled to assume that any trading activity is for a legitimate purpose. Trades without a legitimate purpose are likely to be illegal. Although this judgment applies to market manipulation of listed securities under [section 265](#) of the FMC Act, similar reasoning would apply to trading in unlisted financial products such as Bank Bills.

Any trades without a legitimate purpose are likely to breach [section 19](#) of the FMC Act, which relates to “misleading or deceptive” conduct.

³ These provisions may still apply when trading has an effect on quoted derivative products (such as the Bank Bill Derivatives traded on ASX24)

⁴ Other legal provisions could also potentially apply to manipulative trading in unlisted securities, such as criminal fraud or conspiracy under the Crimes Act or collusion or price fixing under the Commerce Act.

⁵ [2017] NZHC 327 [3 March 2017]

The Warminger judgment is useful as it clarifies what does or does not constitute a legitimate commercial purpose for trading activity. Venning J noted that there may be legitimate purposes for trading other than simply for a buyer to acquire a security at the lowest available price and for a seller to sell at the highest price. In practice, trades may be carried out for other proper and legitimate motives, for example, price or volume discovery and positioning. Such transactions may have an effect on the price of the security but may not be manipulative or create a misleading or deceptive impression in the market.

Venning J agreed with the NSW High Court in *North v Marra Developments Ltd*⁶ that transactions undertaken for the sole or primary purpose of setting or maintaining the market price were not for a legitimate commercial purpose and were illegal.

Our approach

We will apply similar reasoning to any trading in Bank Bills, or other unlisted securities where trading in the security may affect the recorded closing price. If we find evidence of trading undertaken for the purpose of moving the BKBM rate, or another benchmark rate set, we will take appropriate and proportionate action.

We will also apply similar reasoning to any wholesale trading in securities, even where a benchmark or closing rate is not affected.

Where we see trading that appears to have no legitimate commercial purpose, we will look at that trading and take action if appropriate.

⁶ [1981] HCA 68

What are we looking for?

This section outlines the principles we will consider when we look at specific trading conduct in the Bank Bills market or other closing rate markets. Examples are provided for illustrative purposes and to help increase certainty, but it is not possible to cover all eventualities in this guidance.

The main thing we will look for to identify potential trade-based manipulation is to see if trading that is not for a legitimate purpose has occurred. We expect market participants to do the same thing within their organisations.

In the Bank Bills market, we expect banks to think about how they can record contextual evidence that will show what the purpose of any trading activity was – at the time it took place.

The recent Warminger judgment provides useful guidance on what trading conduct has a legitimate purpose. Although ‘purpose’ is not an express element of the relevant legislation, consideration of the purpose behind trades is an important consideration when determining whether there is a breach of the legislation.

Venning J recognised that we cannot look inside a trader’s mind to determine the purpose of their actions, but we can establish their purpose from the market data and other contextual evidence.

To identify poor conduct, market participants need to understand the context of trading as well as merely reviewing trading data.

It is accepted that legitimate trading activity (such as putting new buy or sell prices into the market) may result in moving an observed rate or price. Trading that causes a large price or rate movement will not necessarily signal non-legitimate trading, but we would expect market participants to take a risk-based approach to checking that transactions have a legitimate purpose. This may involve greater review of transactions that have caused a large price or rate movement, or where a small change has led to a

significant benefit for the participant or individual trader.

“In some cases, [the purpose] may be apparent from the market data alone. The aberration in normal trading patterns may be sufficiently significant to permit a finding of intent even in the absence of contextual evidence... However in most cases the context of the trading will be important... There may be direct evidence from letters, emails or telephone communications. There may also be circumstantial evidence which suggests an opportunity or motive to manipulate the market... Proof of intention may be based upon inferences.”

-Venning J in FMA v Warminger

Price and volume discovery

Price discovery and/or volume discovery may be a legitimate purpose for trading. For example, a ‘price-maker’ may put new bids and/or offers into the market to determine where the next traded price might be. The purpose of this activity is to carefully find the new point at which supply and demand for a security meet. This new price will effectively price-in all the current market information by drawing out the views of other market participants by encouraging new buy and/or sell orders from them. The purpose of genuine price or volume discovery trading is not necessarily to move the observed rate or price, although it may often have this effect.

If the main purpose of trading is to move an observed rate or price, this would be an illegitimate purpose and illegal. This trading would be illegal even if the trader has nothing to gain from moving the rate or price, for

example where they think they are helping the market by moving the rate or price to what they believe is the 'true' rate or price – this is a very different purpose from true price or volume discovery.

Understanding the legitimate purpose

Trades conducted for a non-legitimate purpose can look identical to legitimate trades. Therefore, trading staff must fully understand what is expected of them and, where necessary, be able to explain otherwise suspicious trading, and produce evidence to justify the purpose of their trades.

An organisation's staff needs to be made aware, through appropriate training, that it is not enough to just have a genuine intention to trade, without collusion with other parties. The purpose behind the genuine intention to trade is also important.

Legitimate purposes for trading in the Bank Bills market include:

- price or volume discovery
- obtaining funding
- managing a cash position by investing in Banks Bills
- hedging interest rate risk.

Our expectations

We recognise there is already extensive international guidance on trading controls, and there is no 'one-size-fits-all' approach. We endorse the more detailed international guidance mentioned on page 10. We also highlight below six high-level principles we expect banks and other market participants to meet. Different banks and market participants will be able to meet these principles in different ways, depending on the risks present in their business.

We expect banks and market participants to:

1. Ensure their hedging activity is solely aimed at risk mitigation and is never performed for the purpose of influencing or manipulating a rate set or price

This is an overriding principle. A market participant needs sufficient processes and controls to ensure they can be comfortable that trading activity never has the purpose of influencing or manipulating a rate set or price.

2. Ensure conflicts of interest are managed in a way that promotes the fair treatment of customers and other market participants

Potential conflicts of interest may be different for each market participant, but one common potential conflict arises because legitimate risk management activity can cause movements of rates and prices. Controls need to be appropriate for the individual business, but might include information barriers and clear, well-understood trading room policies including standards for execution and hedging.

3. Ensure that customers are aware of the key mechanics of any trading activity that leads to potential conflicts of interest.

Communications should be primarily targeted at ensuring confident and fully informed participation by customers, rather than boiler-plate disclaimers of liability.

4. Influence the culture of trading staff to minimise the risk they might trade for any non-legitimate purpose

We encourage market participants to carefully examine both formal and informal incentive structures. Misaligned incentives can undermine otherwise appropriate processes and communications from senior management and lead to an increased risk of poor conduct.

5. Provide adequate and up-to-date training to all relevant staff on acceptable trading practices and the participant's relevant controls

As well as training trading staff, it is important that those who oversee trading are also well-trained to recognise anomalies, rather than just reconciling trades.

6. Take a risk-based approach to:
 - a. Recording any evidence that might reasonably be expected to show the purpose behind trading activity; and
 - b. Reviewing trading data and contextual evidence to ensure that trading activity has a legitimate purpose.

Oversight should include multiple levels of review as proportionate and appropriate (for example by a compliance team and internal audit) and an escalation process for addressing concerns.

What does legitimate trading look like?

To distinguish between acceptable and illegal trading one must look at whether there was a legitimate commercial purpose for the trading. We recognise that an individual's purpose cannot always be fully shown, but it can often be inferred from contextual information.

This is why our principles say that market participants should take a risk-based approach to recording any evidence that might reasonably be expected to show the purpose behind trading activity. It is also important for oversight and compliance functions in firms to be able to review this contextual evidence so that the market participants are satisfied that their staff are only trading for legitimate purposes.

Where trading causes us concern, based on the specific orders and/or trades, we will ask the market participant to show us how they are confident that the purpose behind the trading is legitimate.

Demonstrating good conduct

We encourage market participants to gather and record any direct evidence of the purpose for trading so as to evidence that purpose. In particular, we encourage banks trading in the Bank Bills market to ensure a clear trading strategy is agreed and recorded in advance of any relevant trading period, and a short explanation of any deviations from the strategy is recorded after the relevant trading period. These explanations do not need to be extensive. A bank should consider what level of detail is sufficient for it to assure itself that trading has been for a legitimate purpose, taking into account all other relevant controls.

We may carry out spot checks on order and trading data and ask how market participants are comfortable that higher-risk trading is legitimate. We may request records of any trading activity in Bank Bills or closing

rate markets (whether inside or outside the relevant rate-set trading windows) and records of the bank's relevant exposure to those rate sets at those times. Records of orders and any supporting information of the legitimate purpose of any higher-risk trading should be kept for at least seven years.

One reason we want to ensure banks and other market participants put in place checks of their trading conduct – and why we carry out spot checks if necessary – is to rebuild confidence in wholesale markets integrity.

We will continue to work with banks and other market participants to ensure they fully understand our expectations and can provide data to us, if requested, without undue compliance costs. Businesses should be committed to ensuring all trading is only for legitimate purposes. We will ensure our responses to any issues they self-identify are proportionate and consistent, as this supports more robust, liquid markets.

Other sources of guidance

The [FMSB Standards](#) relate to conduct around reference price transactions in the wholesale fixed income markets. They recognise analogous transactions exist in the commodity and currency markets, but do not specifically apply to those markets. The FMSB Standards recognise the potential conflicts of interest described in this report and provide useful principles and guidance for banks to apply when trading in Bank Bills and other fixed income markets.

The Bank of International Settlement recently issued an [FX Global Code](#) that sets out a common set of guidelines to promote the integrity and effective functioning of the wholesale foreign exchange market. We support the introduction of the FX Global Code, and many of its principles would apply to the Bank Bills market and other Closing Rate Markets.

Glossary

Term	Definition
Bank Bill	A short-term transferrable instrument under which a bank is liable to pay the holder a specified amount on a specified maturity date. The instrument can be on-sold and the maturity date is generally between 30 to 180 days after issue.
Benchmark	<p>The International Organization of Securities Commissions (IOSCO) defines benchmarks in its Principles for Financial Benchmarks report (the IOSCO Principles) as prices, estimates, rates, indices or values that are:</p> <ol style="list-style-type: none">Made available to users, whether free of charge or for payment;Calculated periodically, entirely or partially by the application of a formula or another method of calculation to, or an assessment of, the value of one or more underlying interests; andUsed for reference for purposes that include one or more of the following:<ul style="list-style-type: none">determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments;determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument; and/ormeasuring the performance of a financial instrument.
Benchmark administrator	The person or organisation responsible for determining the methodology, calculating the benchmark and disseminating the results. In New Zealand this is the New Zealand Financial Markets Association (NZFMA) for BKBM and most closing rates.
Closing rates	The market closing price or rate for various government bonds; non-government bonds; interest rate swaps; overnight index swaps periodically calculated and published using a consistent methodology.
Closing Rate Markets	The markets in any of the underlying securities for which the NZFMA administers closing rates.
IOSCO Principles	The principles set out in the Principles for Financial Benchmarks report published by the International Organization of Securities Commissions.
Rate-set window	The period of time during which transactional data is captured to calculate a benchmark, which for BKBM is the two-minute period between 10.20am and 10.22am.

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