GUIDANCE NOTE GN0015/08 – MARKET MANIPULATION

Introduction

This Guidance Note:

- Provides interpretative assistance on those NZX Participant Rules (Rules) governing market manipulation.
- Reminds Market Participants and their Employees of their obligations in relation to market manipulation.
- Outlines NZX’s expectations in relation to good practice on the part of a Market Participant and those of its Employees who advise and/or trade and/or place orders into the market (including without limitation Dealers, DMA Dealers and NZX Advisors or Associate Advisors).
- Identifies examples of trading activity that NZX considers to be unacceptable and in breach of the Participant Rules because it is manipulative.

In addition to being a breach of the Rules, market manipulation is also an offence under the Securities Markets Act 1988. This Act is enforced by the Securities Commission; please see http://www.newsecuritieslaw.govt.nz/overview/ market-manipulation/index.php for further information.

For the avoidance of doubt, the requirements of Rule 10.2 and this Guidance Note do not replace or diminish a Trading Participant, NZX Advising Firm or Advisor’s statutory obligations including, but not limited to, the Securities Markets Act 1988.

What is Market Manipulation?

NZX seeks to ensure that its markets are fair and orderly, this necessarily involves ensuring they are free of manipulative trading. A fundamental component of fair and orderly markets is that they reflect genuine supply and demand and have information flows that accord with applicable securities law. NZX undertakes active supervision of trading occurring on its markets in furtherance of this objective. NZX has certain rules that govern manipulative conduct. Under Rule 10.2 each Trading Participant, NZX Advising Firm and Advisor must ensure that Orders they are placing do not, and are not likely to, manipulate the market.
“10.2.1 Every Trading Participant, NZX Advising Firm and NZX Advisor is prohibited from placing an Order for, or dealing in, any Securities:

(a) Either when Acting as Principal or placing that Order has the effect, or in the opinion of NZX is likely to have the effect, of creating a false or misleading appearance:

(i) of active trading in any Securities; or
(ii) with respect to the market for, or the price/yield of, any Securities; or
(iii) the Trading Participant, NZX Advising Firm or Advisor intends to create the effect of any of the circumstances in Rule 10.2.1(a) (i) or (ii); and

(b) On behalf of a client or any other person where that Trading Participant, NZX Advising Firm or Advisor intends to create, or is aware that that client or other person intends to create, or that Trading Participant, NZX Advising Firm or Advisor should reasonably suspect that the client or other person intends to create the effect of any of the circumstances in 10.2.1(a)(i) or (ii).

10.2.2 When accepting an Order each Trading Participant, NZX Advising Firm and Advisor, must consider the following:

(a) Whether that Order, or the execution of that Order, is consistent with recent trading in that Security, taking into account current market conditions;

(b) Whether that Order, or the execution of that Order, will materially affect the market for, or price/yield of, any Security;

(c) Whether that Order is received during Trading Hours or after the market has closed, and whether instructions about when that Order is to be entered have been received from the client;

(d) Whether the client who has entered/submitted that Order, or any other person who the Trading Participant, NZX Advising Firm or NZX Advisor knows to be a Related Party of that client, may have a beneficial interest in creating a false or misleading market in, or the price/yield of, any Security.

(e) Whether there are any additional unusual requests in relation to that Order, including but not limited to requests in relation to settlement and delivery;

(f) Whether that Order appears to be one in a series of requested Orders and whether that series of Orders has any of the effects outlined in this Rule 10.2.2; and

(g) Whether there is a clear legitimate commercial reason for that Order being placed, which is unrelated to the intention to create a false or misleading market in respect of the market for, or price/yield of, any Securities.

10.2.3 For the avoidance of doubt, the obligations imposed on each Trading Participant, NZX Advising Firm and Advisor in relation to the requirement not to create a false or misleading market for, or price/yield of, any Securities also applies in respect of Orders the subject of Direct Market Access.”

Conduct that may not amount to a breach of Rule 10.2 may still be prohibited under the Rules, specifically Rule 8.1, if it is otherwise unethical, unfair, or likely to be detrimental to the wellbeing or proper conduct of any client of that Market Participant and/or that Advisor and/or
NZX, and Rule 10.14.9, which prohibits trades where there is no change in beneficial ownership.

Generally, trading activity conducted in accordance with the Rules and Good Broking Practice, as defined in the Rules, will not be considered manipulative. However, this will be assessed on the nature of the transaction and the underlying intent.

**Securities Markets Act 1988 (SMA)**

Amendments made to the SMA prohibit market manipulation, specifically:

1. Sections 11-11D prohibit:
   - making statements or spreading information which is false or misleading in regard to a material matter and which is likely to induce a person to trade or which might affect the price of the securities; and
   - creating a false or misleading appearance of securities trading.

2. Under these sections, a person commits a criminal offence when they have actual knowledge that a statement, or information, is materially false or misleading, or that conduct will have, or is likely to have, the effect of creating, or causing the creation of, a false or misleading appearance. Civil liability can arise if the person either knows, or ought to know, of the misleading effects of the statement or conduct.

3. Under Section 11C any trade that does not result in a change of beneficial ownership or where a person places matching buy and sell orders for a security without a change in beneficial ownership will be presumed to give a false or misleading appearance of trading activity unless it can be shown that the transaction took place for a legitimate reason.

4. Section 13 provides a broad-ranging prohibition against any conduct related to any dealings (not only trading) in securities (both listed and non-listed) that is likely to mislead or deceive. This is similar to the prohibition in Section 9 of the Fair Trading Act 1986 for misleading or deceptive conduct.

Pursuant to regulations made under the SMA it is clarified that certain market conduct is permissible in certain circumstances as defined in those regulations. For example:

- Market Stabilisation conduct is permissible subject to requirements which include market notification and appointment of a stabilisation manager, who must follow certain stabilisation protocols;
- Short Selling and Crossings are not presumed to be market manipulation, merely by reason of being short selling or crossing.

A person who contravenes section 11 may be liable for:
- a maximum penalty of 5 years’ imprisonment; and or
- a $300,000 fine (individual) or $1,000,000 fine (body corporate).

Other available penalties include:
- Prohibition and corrective orders by the Securities Commission
- Pecuniary penalty orders by the Court.
- Compensatory orders by the Court.
Prevention of Market Manipulation

Rule 10.2 is concerned with preventing manipulative trading in the following areas:

- When trading as principal either,
  - With an intention of; or
  - In a manner that has the effect, or is likely to have the effect of,
    creating a false or misleading appearance of active trading in any Securities or with respect to the market for, or the price/yield of any Securities (Rule 10.2.1(a)).

- When trading on behalf of a client either,
  - Where the Market Participant has an intention of, or
  - Where the Market Participant is, or should be, aware that the client has intention of,
    creating a false or misleading appearance of active trading in any Securities or with respect to the market for, or the price/yield of any Securities (Rule 10.2.1(b)).

Rule 10.14.9 is concerned with situations where a trade is effected and no change in Beneficial Ownership occurs as a consequence of that trade.

To assist Market Participants to understand these obligations at a practical level, this note provides guidance on areas of higher risk where market manipulation could be more prevalent. This note provides examples of trading activity that could be manipulative and accordingly in breach of the Rules. Whether the conduct is in fact manipulative, i.e. whether it creates or is intended to create a “false or misleading” impression will need to be determined on the facts of each case. In each example provided below NZX considers there is a prima facie case to consider that the conduct in question manipulates the market.

Trading with No change in Beneficial Ownership

Rule 10.14.9 provides:

“All Orders entered into the Trading System by a Dealer, or DMA Dealer or DMA Authorised Person for his or her Trading Participant who is Acting as Principal or for an NZX Advising Firm who is Acting as Principal must result in a change in Beneficial Ownership. Where the DMA Authorised Person is a client of the Trading Participant orders entered by that DMA Authorised Person must result in a change in Beneficial Ownership.”

This rule prohibits trades where no change in beneficial ownership has taken place, either when trading as principal or on behalf of clients.

Notwithstanding this Rule, NZX policy is not to take action in the event of a breach where the Market Participants effect such transactions when it can prove that there was no reason for that Market Participant to suspect that a change in beneficial ownership would not occur or when it can show that the purpose for the order was not to create a false or misleading market for or price for the Security, if for example there was a legitimate purpose and the appropriate flags were used.

There are circumstances where a transaction is effected for a client by a Market Participant when there is no change of beneficial ownership; the client requires that the transaction is recorded. An example of this is a scenario where a fund manager may change the legal owner of Securities between funds, but there is no change in beneficial ownership. With the introduction of its new trading system, NZX will introduce a Put-through trade flag. This will enable such a transaction to be reported, and will readily disclose the nature of the transaction.
as having had no change in beneficial ownership. In these circumstances, where the trade is appropriately flagged a false or misleading impression is not created.

Areas for Market Participants to be mindful of include:

Inadvertent Crossings – the advent of DMA and electronic trading may give rise to a crossing occurring as a result of orders being entered through DMA by a Market Participant’s DMA Authorised Persons that match with a pre-existing order of the Market Participant already in the Trading System. This activity is of itself not of concern, however in some instances this activity may give rise to transactions for which there is no change in beneficial ownership. An example could be where orders entered by different divisions of the Market Participant that are physically and appropriately, for conflict management purposes, separated (for example a market maker desk and a principal trading desk), match. In this instance should orders in these two divisions match no change in beneficial ownership will occur.

NZX accepts that a Market Participant may have multiple DMA DPOP authorised persons entering orders that could result in inadvertent matching of principal orders. Specific examples include where:

- A Market Participant’s overseas parent company enters orders through DMA; or
- Program principal trading is conducted by different divisions of a Market Participant.

In these instances, NZX does not consider that trades having no change in beneficial ownership create a false or misleading appearance of active trading provided they were conducted at arms length, for example where:

- The trades have not been pre-arranged;
- The same DMA Authorised Person has not entered each side of the trade; and
- The orders originated from segregated areas of a business or from a defined programme.

Accordingly, whilst in breach of the Rule it is NZX’s policy not to pursue disciplinary action, provided the Market Participant’s crossing can be shown to be “accidental”.

NZX expects that these trades will be monitored by the Market Participant to ensure that they remain “accidental” in nature. NZX Surveillance will also monitor such trading activity and therefore it is important that market maker and principal trading activity are appropriately flagged in the trading system.

For the avoidance of doubt, trades where these tests cannot be met should be cancelled.

Trading As Principal

Trading (Acting) as Principal is defined in the Rules as:

“acting in a transaction where a Trading Participant or a Prescribed Person is a Beneficial Owner of part or all of the Securities at any stage in the transaction”.

For the avoidance of doubt, principal trading includes facilitation activities.

Rule 10.2 is concerned with two circumstances in respect of principal trading:

- an intention on the part of the Market Participant to mislead or deceive; or
- the effect, or likely effect, of placing an Order by that Market Participant.

It is important to be aware of the two limbs of this Rule. The first is concerned with the intention of the Market Participant. Accordingly the actual effect of the Order is not relevant. The second is concerned with the actual or likely effect of an Order and therefore intention is
irrelevant, and an objective assessment of whether a false or misleading impression has been created is necessary.

Areas for Market Participants to be mindful of include:

Trading around the Close

Buying or selling Securities at the close of the market (generally around 20 minutes of the market close and during pre-close), with the effect of:

- misleading investors who act on the basis of closing prices; or
- artificially setting the closing price,

is considered manipulative and a breach of the Rules. This is commonly referred to as marking the close. A common indicator of marking the close is the entering of small orders into the trading system, at prices which are higher than the previous best bid or lower than the previous best offer, in order to move the price of the Security. This conduct will be investigated by NZX.

Trading at the close is also relevant when trading on behalf of clients; please see further comments on pg 8. A Market Participant is not precluded from accepting Orders that are received towards the end of the day or closing price Orders, but care needs to be taken to ensure that trading around the close does not contravene the Rules or relevant legislation. The following should be taken into consideration when acting as principal (or on behalf of a client):

(i) Whether the size of the transaction to be undertaken will materially affect the closing price. In this case the Market Participant should consider not entering or accepting the Order;

(ii) Where a Market Participant accepts an Order whereby it benefits through purchasing Securities at a lower price during the day it should consider its execution approach, particularly with respect to the effect the execution may have on the closing price as this may breach the Rules. In this situation the Market Participant benefits from setting the price at close as high (or low) as possible and therefore could have motivation to materially affect the closing price; and

(iii) Transactions that appear to have no commercial purpose, apart from attempting to manipulate or set the closing price.

For the avoidance of doubt a Market Participant may accumulate or bundle Orders, delay executing client Orders, or delay Orders to facilitate crossing provided that pursuant to Rule 15.4.2, the client has provided consent for the Market Participant to execute the Order at its discretion.

Trading for Volume

Principal trading to facilitate client instructions does promote liquidity and in itself is not considered manipulative. This activity provides access to pools of liquidity outside of the market depth as indicated on the central limit order book. In this situation, a Market Participant takes risk and uses its balance sheet to facilitate client trading activity. However, a Market Participant who uses its Principal book in order to act as a middleman between client agency trades would, prima facie, be considered to be trading for volume. This conduct is considered by NZX to be misleading as it creates a false impression of trading activity and accordingly is in breach of the Rules.

A key determinate for considering whether a Market Participant is in fact Acting as Principal, rather than merely a middleman, will be whether or not the Market Participant assumed risk as a result of the transaction, in addition to there being a change in beneficial ownership. Factors giving rise to principal risk include the Market Participant assuming price risk, differences in
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Timing of receipt of client buy and sell orders etc. Whether Principal risk existed in a transaction will be determined on the facts of each instance. For the avoidance of doubt, simply booking a transaction through a Principal book is not considered sufficient justification for classifying a transaction as Principal.

Index Replication Orders
Market Participants should be conscious of Orders replicating an index, or purchases for clients who operate index funds. While there is valid commercial purpose for these trades to be transacted at close, care should be taken to ensure that this activity does not create a material and potentially misleading price impact.

Trading on behalf of Clients
Rule 10.2.1(b) is concerned with placing Orders for clients where the Market Participant:

- has the intention of creating a false or misleading appearance; or
- is aware, or should have been aware, that its client intends to create a false or misleading appearance.

Rule 10.2.2 sets out mandatory considerations that a Market Participant must have regard to when accepting Orders.

This Rule embodies a key requirement for a Market Participant to consider the nature and impact of client instructions rather than accepting them without question. These are set out below with additional commentary.

(a) Whether that Order, or the execution of that Order, is consistent with recent trading in that Security, taking into account current market conditions;

This aspect of the rule requires a Market Participant to exercise its judgement, based on its experience and knowledge of trading in the Security.

(b) Whether that Order, or the execution of that Order, will materially affect the market for, or price/yield of, any Security;

Clients will generally want to obtain the best price. However from time to time there may be genuine reasons why a client might be satisfied with a lower/higher price, e.g. the need to sell/buy quickly. The price for a Security is affected by many factors; however the underlying liquidity of that Security is a chief determinant of price. In a broad context, Market Participants will be expert in relation to liquidity of particular Securities and should be able to judge whether the execution of an Order would materially affect the market for or the price/yield of a Security. If the Market Participant considers that the Order would materially affect the market for or the price/yield of a Security, the Market Participant must assess the purpose of the Order to determine whether it is genuine or manipulative. Examples of circumstances where a Market Participant should query a client order include:

- Receiving instructions to buy up, or sell down, to a specified price that will materially affect that price or without apparent concern as to the volume;
- Receiving instructions to sell stock but also receiving instructions to enter large disclosed or undisclosed bids just below the priority bid. Particular attention should be paid to instructions to enter bids during the Pre-Open and then withdraw those orders prior to the commencement of Normal Trading.

A Market Participant receiving an Order which would result in a material price movement should consider the terms of the Order and whether it should be executed. If a Market
Participant has satisfied itself as to the legitimate commercial reason and there is no prohibited intention present, there is no reason why the Order should not be executed.

(c) Whether that Order is received during Trading Hours or after the market has closed, and whether instructions about when that Order is to be entered have been received from the client;

As with Trading as Principal, particular care needs to be paid when receiving instructions to place an Order at or near the close (in this regard please see the comments on pg 5 & 6). A Market Participant that receives an Order well before market close with instructions to execute at or near the close should query the client why they want the order executed in that way, particularly if a specific price is set. NZX expects all Market Participants to be able to recognise orders that are intended to fix the closing price over seeking closing price for a valid commercial purpose. Market Participants should be even more vigilant in respect of Orders placed with instructions to execute at or near the close on the last trading day of a month, quarter or year, where such Orders will move the price when executed. It is incumbent on a Market Participant to consider whether the client is seeking to fix the closing price in these circumstances, particularly given the nature of the client itself, for example a Fund Manager wishing to trade near close of the last day of a quarter.

Market Participants need to consider when acting on behalf of their clients who track an index the impact of Orders to trade in Securities joining or leaving that index which may materially move the market for that particular Security. In regards to placing trades for index order clients, Market Participants should take into account the trading around the close guidance. More obvious examples include clients asking the Market Participant to obtain a certain closing price for a given stock, or asking what volume would be required to be bought or sold to achieve a specific price.

When considering whether conduct is in fact manipulative NZX will consider, among other things, the extent to which Orders to trade are given, or transactions undertaken, within a short time span in the trading session and lead to a price change which is subsequently reversed.

(d) Whether the client who has entered/submitted that Order, or any other person who the Trading Participant, NZX Advising Firm or Advisor knows to be a Related Party of that client, may have a beneficial interest in creating a false or misleading market in, or the price/yield of, any Security;

A Market Participant, when receiving an unusual Order, needs to satisfy itself that the client, or parties related to the client do not have an interest in creating a false market for, or price/yield of a Security. This consideration should extend beyond the client to parties related to the client.

Examples include:
- Orders placed by a large holder of the Security who has an interest in inflating the value of that holding;
- Orders placed by a Related Party of a company, when the company is a takeover target, the motivation being to obtain a better price in the takeover

(e) Whether there are any additional unusual requests in relation to that Order, including but not limited to requests in relation to settlement and delivery;
An example includes a situation where a client places a buy Order, but only settles this with subsequent sell Orders. This may be indicative of a strategy to push a price of a Security higher. The strategy may also result in a false or misleading appearance of active trading.

\( f \) Whether that Order appears to be one in a series of requested Orders and whether that series of Orders has any of the effects outlined in this Rule 10.2.2;

A client who requests a Market Participant to place an Order into the market in small quantities over an extended period of time should be queried as to the strategy. Likewise, a consistent pattern whereby a client forgoes a better price intra-day to trade around the end of day should be questioned.

\( g \) Whether there is a clear legitimate commercial reason for that Order being placed, which is unrelated to the intention to create a false or misleading market in respect of the market for, or price/yield of, any Securities.

Whilst many Orders that may change the market for or price/yield for a Security may have legitimate commercial reasons the Market Participant needs to be aware of any ancillary motives to manipulate that exist alongside the legitimate commercial motive. Orders that have a genuine commercial reason are acceptable, despite the price impact that they may have, provided that the Market Participant does consider ulterior motives and executes the Order in an appropriate way bearing in mind its market obligations.

Factors to consider

NZX considers that it is difficult to document specific examples where market manipulation will as a matter of fact have occurred. There will be a number of instances where “abnormal” trading activity will be reviewed or investigated by NZX Surveillance staff. NZX considers it appropriate to indicate factors that will be taken into account in any investigation. These are by no means intended as a definitive set of factors, but constitute areas that may be considered.

Liquidity

NZX recognises that the NZ market place is unique in its level of liquidity and that outside the top 50 Securities there is limited liquidity. In itself, this may be a valid explanation for an abnormal and/or short term price movement.

Underlying client orders and their intentions

As noted above, an abnormal trading pattern for a single client may suggest underlying intent to manipulate or create a false impression. Where client driven, NZX would seek to understand the motivation for trading in a particular way, especially if this meant that the client was trading in such a way that would not appear to be in their best interests.

In such instances, NZX would investigate further in respect of the client and the timing and nature of their instructions. A key underlying consideration is whether the Order reflects a valid commercial purpose.

Volume and value and frequency of trades

NZX would query small Orders being entered for a Security over an extended duration, or being entered at or near close, NZX would wish to understand the reason for trades being executed in such a manner.

In addition, NZX would query abnormal trading activity around corporate events or milestones, for example an end of month or quarter.
Orders at Close
The introduction of the pre-close session and random closing match makes Orders entered in
the pre-close, with the intent to fix the closing price, more obvious. NZX will monitor the timing
and nature of Order entry through the pre-close session in addition to monitoring of trading
activity near the end of normal session. Activity, for example, such as entering Orders late in
the pre-close session, or entering Orders in pre-close and withdrawing immediately afterward,
that has the appearance of influencing the closing price, will be investigated by NZX.

Change of Beneficial Ownership
The correct use of trade account flags will save Market Participants from unwarranted
investigation. For example, crossings marked with trade accounts as Principal to Principal
would indicate that no change in beneficial ownership had occurred.

Materiality
Where it is relevant, the following factors will be considered in assessing materiality:
  o A benchmark of past trading history of a specific Security;
  o Absolute value of price impact;
  o Percentage price or volume movement;
  o Market Capitalisation of the issuer; and
  o Market reaction.

Order Records
NZX reminds participants of Rule 10.6 which provides:

  “Each Trading Participant must ensure the conduct of an orderly market. In particular
each Trading Participant must:

  (a) Keep and maintain records of the time and date of receipt of each Order as part
      of the accounting records required by these Rules;

  (b) Be solely responsible for the accuracy of Orders entered/submitted into the
      Trading System in accordance with the procedures for use of the Trading
      System established from time to time by NZX to ensure the efficiency and
      integrity of the markets provided by NZX;

  (c) Maintain and enforce at all times appropriate security procedures designed to
      prevent unauthorised entry into the Trading System; and

  (d) Answer, and provide evidence (written evidence if requested) in support of any
      request by NZX in respect of that Trading Participant’s compliance with these
      Rules, and/or any direction issued from time to time by NZX or compliance with
      Good Broking Practice. If requested, that Trading Participant must provide NZX
      with independent verification (by an organisation or person approved by NZX)
      of that Trading Participant’s compliance with these Rules and/or any directions
      issued from time to time by NZX or compliance with Good Broking Practice.”

NZX considers that good record keeping is paramount, particularly when a Market Participant
is the subject of an investigation either by NZX or other regulatory bodies. Order records
provide an audit trail that explains why an Order was entered into the Trading System and
should accurately reflect the client’s instructions, the Market Participant’s inquiries of the
client, if any, and the subsequent action of the Market Participant. Deficiencies in these
records may prohibit the Market Participant’s ability to adequately address inquiries that NZX
(or the Securities Commission) may have. While not a specific rule requirement, the
existence of voice recording may assist a Market Participant in its defence of an allegation of
manipulation.
In addition, Market Participant’s should ensure where there is concern over a particular Order or trade, that the actions taken, inquiries made etc should be recorded and be available for external review.

Insider Trading

NZX also reminds Market Participants that amendments to the SMA have also been made with regards to Insider Trading. Whilst Market Manipulation and Insider Trading are separate issues, NZX believes it is appropriate in this Guidance Note to also draw attention to Market Participants’ obligations under the NZX Participant Rules in respect of insider trading.

Rule 15.6 provides:

“15.6.1 Each Client Advising Participant must have policies and procedures in place for referring all instances of suspected insider trading by a client to that Client Advising Participant’s Compliance Manager.

15.6.2 Each Compliance Manager of a Client Advising Participant must maintain a written record of all referrals of suspected insider trading referred to him or her pursuant to Rule 15.6.1.

15.6.3 Each Compliance Manager of a Client Advising Participant must have policies and procedures in place for the Compliance Manager to investigate all instances of suspected insider trading by a client and report these to NZX.”

These Rules require systems and processes to be in place so that insider trading can be referred to a Market Participant’s Compliance Manager and for these to be investigated and referred to NZX. In certain circumstances this may also include referral by a Market Participant to the Securities Commission.

This process relies upon a Market Participant’s Advisors and Dealers being mindful of the relationships a specific client may have and the nature of their Order instructions relative to these relationships.

If a Market Participant considers that there is information inequalities in the market for any Security or that there is unusual trading activity in any Security that Market Participant is encouraged to contact Surveillance at +64 4 495 2829 (surveillance@nzx.com). Such contact is kept confidential.

If a Dealer or Advisor of a Market Participant has any query or concern about a specific Order or transaction they should in the first instance contact their Compliance Manager before proceeding.

Other resources