

An aerial photograph of a dense, green forest. A light-colored, winding road or path cuts through the center of the forest, curving from the left towards the right. The trees are tall and closely packed, creating a textured canopy of various shades of green. The lighting suggests a bright day, with some areas of the forest appearing slightly brighter than others.

INTERPRETATION OF THE TRADING CONDUCT PROVISIONS

Summary of interpretative aids

27 August 2018

Interpretation of the trading conduct provisions

1. Introduction

- 1.1 You asked us to consider what case law, concepts and other guidance a court might utilise in determining a trading conduct case under the Electricity Industry Participation Code 2010 (the **Code**). In particular, you asked whether Financial Markets Authority case law and principles from other jurisdictions/markets might be utilised in determining the meaning of the “high standard of trading conduct” referred to in clause 13.5A of the Code (the **trading conduct provisions**).
- 1.2 We understand that the Electricity Authority’s (the **Authority**) Market Development Advisory Group (**MDAG**) is currently reviewing the trading conduct provisions of the Code. It therefore seeks guidance as to what principles might be implied by the existing wording as well as concepts which might be imported into the Code in future to make the trading conduct regime more robust. We further understand that MDAG has received feedback that some market participants expect certain historical practices to comply with a “high standard of trading conduct” because they are well-established. MDAG has queried whether there is guidance available on this.
- 1.3 This paper sets out, in a summarised format:
- the overall approach we would expect a court would take to interpreting the trading conduct provisions (if the matter ever came before a court);
 - regulatory regimes with similar requirements to the “high standard of trading conduct”;
 - regulatory regimes which may set benchmarks for conduct that would likely fall below the “high standard of trading conduct”; and
 - additional observations on what options may be available to increase certainty and on the treatment of historical practices.

2. Court’s likely approach to interpretation

- 2.1 In interpreting the trading conduct provisions, we would expect a court to first consider:
- the purpose of the Code as set out in s 32 of the Electricity Industry Act 2010 (the **Act**);
 - internal aids to interpretation i.e., other provisions of the Code which suggest that the trading conduct provisions should take a particular meaning (e.g., the safe harbour provisions and the interrelationship with the provisions relating to undesirable trading situations);
 - external aids to interpretation, particularly documents generated in the development of the trading conduct provisions, such as the Authority’s consultation papers and supplier submissions; and
 - potentially, industry practice (although noting our comments below regarding historical practices).
- 2.2 Only where consideration of the above fails to produce a conclusive view on the correct interpretation in a particular factual context, is a court likely to then look to other materials to assist in determine the meaning of a “high standard of trading conduct”. Potentially relevant materials could include any case law, guidance notes and other commentary that suggests what may be captured by this phrase. Such materials may be found in other market trading contexts:
- which have a requirement similar to the Code’s “high standard of trading conduct” to establish how that specific requirement has been interpreted in those other contexts; and
 - which, while not containing a similar phrase to the Code, have set out what conduct is considered generally unacceptable and which may, by analogy, fall below the required “high standard of trading conduct”.

We discuss each of these below.

3. Markets with a similar requirement to a “high standard of trading conduct”

3.1 In our review of potentially analogous regulatory regimes (see Diagram 2 below for a summary of the regimes we have reviewed), we have not located any regimes with an identical or even similar requirement for parties to meet a “high standard of trading conduct”. The closest comparators we located are:

- Nord Pool’s Market Conduct Rules, which provide at rule 3 that parties “must not apply unreasonable business methods” and must “always seek to act in accordance with good business practice”; and
- NZX’s Participant Rules, which require at rule 8.4 that market participants and advisors “observe Good Broking Practice”.

3.2 While these are similar to the Code, we did not locate any case law regarding the Nord Pool rules, and Nord Pool itself has not issued any guidance as to the meaning of rule 3. As such, there is no additional material to suggest how rule 3, and by analogy or extension the Code’s trading conduct provisions, might be interpreted.

3.3 There is similarly no case law regarding NZX’s requiring “Good Broking Practice”. But, this phrase is defined in rule 1.1 of the Participant Rules as:

...conduct that is, at the discretion of NZX, in the wider interests of the markets operated or provided by NZX, the New Zealand Securities markets and investors and which complies with the spirit and intent of the practices, procedures and requirements as set by NZX in:

- (a) these Rules; and
- (b) the Procedures, any Guidance notes, Practice Notes, documents, policy statement or direction issued from time to time by NZX...

3.4 In addition to this broad definition, NZX has issued a “Participant Guidance Note: Trading Conduct”, which indicates that its purpose is:

...to provide guidance to NZX Participants in relation to Good Broking Practice in the areas of trading conduct encompassed by the NZX Participant Rules and NZX Derivatives Rules...

Diagram 1 below sets out the areas which the Participant Guidance Note suggests form part of “Good Broking Practice”.

3.5 The areas set out in this NZX Guidance Note appear useful and may provide some general guidance (as further discussed in section 4 below) but, in our view, may ultimately be of limited persuasive value to a court interpreting the trading conduct provisions because:

- the guidance is confined to consideration of broking practices. By contrast, the trading conduct provisions apply to generators and ancillary service agents who perform different roles from brokers and would likely be subject to different expectations;
- it is only one regulator’s view of what constitutes good practice in a market; and
- the regulator in this case, NZX, operates quite differently to the Authority, in that while it is a regulator, it also acts with a commercial focus.

Diagram 1: NZX’s Good Broking Practice



4. Conduct which is unacceptable in other markets

- 4.1 If there are no rules/regulations that are substantially the same as clause 13.5A of the Code to assist interpretation, a second reference point that a court may look to are any comparable regulatory regimes and markets with *similar* rules, associated case law and other guidance. Such comparators may still assist a court in determining what conduct may fall short of a “high standard of trading conduct”.
- 4.2 A court looking at other regimes for guidance would likely consider the similarities between the New Zealand electricity market and the market under consideration, with approaches developed in substantially similar markets likely to be most persuasive. Factors a court may consider in assessing whether or not a market is sufficiently similar as to be relevant may include whether:
- the market is situated in a comparable jurisdiction;
 - the market operates as a national market, as the New Zealand electricity market does;
 - the market has a central clearing system;
 - the market is trading in physical or purely financial products (with physical product markets more relevant to trading conduct within the New Zealand electricity spot market, while financial markets may be more relevant when considering other electricity markets like the OTC hedge market and the financial transmission rights market);
 - the regulator has similar qualities to the Authority. For example, whether the regulator is a corporate or statutory body and whether it has similar functions; and
 - the regulator takes a similar principles-based approach.
- 4.3 Diagram 2 at the end of this section 4 sets out how we expect a court to view the relevance of the various markets we have considered in preparing this advice. In summary, we would expect that a court would be most persuaded by practices in the Australian electricity market as well as the New Zealand financial markets. This would include both the regulations and guidance issued in respect of those markets as well as any case law gloss on a statutory provision/regulation (such as the Court’s view that misleading conduct under the Financial Markets Conduct Act 2013 includes conduct with an improper purpose¹).

¹ See *FMA v Warminger* [2017] NZHC 327.

4.4 We further note that, while there are features of the New Zealand electricity market which are unique (including, for example, the existence of the HVDC link), we do not consider that such features should exclude any and all reliance on principles developed in other markets. While every market will have unique features, there is a sufficient degree of commonality that behavioural standards should be relatively consistent. Indeed, the European and UK regimes appear to envisage some overlap between regulatory regimes for financial and electricity markets. In particular, we note that:

- the European Regulation on Wholesale Energy Market Integrity and Transparency (**REMIT**) notes that “accepted market practices such as those applying in the financial services area... could be a legitimate way for market participants to secure a favourable price for a wholesale energy product” and thus avoid breaching provisions prohibiting market manipulation;² and
- the UK Financial Conduct Authority has indicated that the vast majority of its Handbook for businesses and participants in financial markets also applies to energy market participants.³

4.5 There may be particular cases where the existence of certain features of the New Zealand electricity market are in issue that make comparisons with other markets harder (for example, issues associated with the role of the HVDC link) but we would expect such cases to be few and far between.

4.6 In addition to considering what conduct is acceptable in individual comparable markets, we consider that a court would also be persuaded by evidence that certain standards of conduct are consistent across several markets. In particular, we consider that the universality of the following provisions makes it highly likely that they form part of a “high standard of trading conduct”:

- prohibitions on market manipulation, including:
 - o prohibitions on misleading trading;
 - o prohibitions on misleading conduct more generally;
 - o prohibitions on trading with an improper purpose; and
- restrictions on information asymmetry (i.e. insider trading).

4.7 Diagram 3 at the end of this section 4 identifies which markets have adopted each of the above. We note that the above represent conduct which is likely to fall well below the required “high standard of trading conduct”. As such, we expect that additional (less serious) trading behaviour could also be considered unacceptable in a Code context (although the line is somewhat unclear).

² Recital 14.

³ At [EMPS1.2].

Diagram 2

Relevance of alternative markets

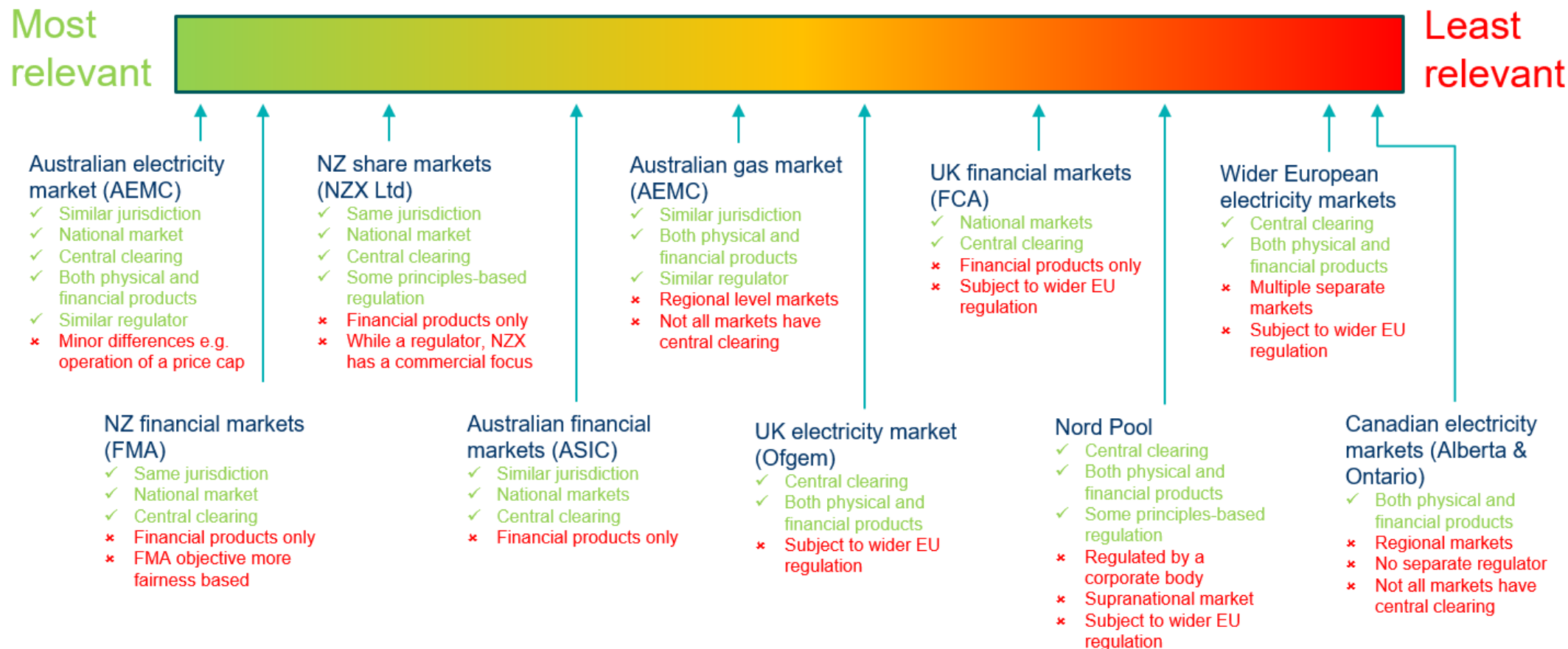


Diagram 3

Themes from alternative markets

Market	Misleading trading / market manipulation	Misleading conduct generally	Improper purpose in trading	Information asymmetry (insider trading)
Australian electricity	✓	✓ covered by general consumer law	✓ covered by general consumer law	✓ covered by general competition law
NZ financial	✓	✓	✓	✓
NZ share	✓	✓ covered by the FTA and FMCA	✓	✓
Australian financial	✓	✓	✓	✓
Australian gas	✓	✓	✓ covered by general consumer law	✓ covered by general competition law
UK electricity	✓	✓	✓ covered by general competition law	✓ covered by general competition law
UK financial	✓	✓	✓	✓
Nord Pool*	✓	?	?	?
European electricity	✓	✓	✓	✓
Canadian electricity	✓	✓	?	✓

? = may be included owing to broad wording of the relevant provisions

* in Norway

5. Additional observations

- 5.1 As we understand it, MDAG is currently in the process of considering whether and how the Code might be modified/expanded upon to increase the robustness of the current trading conduct provisions. While a full options paper is beyond the scope of our instruction, we note that the markets we have considered have taken a range of approaches to the issue of providing certainty around principles-based regulation. Such approaches have included:
- doing nothing and allowing the provision to speak for itself;
 - providing further detail in regulation;
 - providing additional guidance, which does not have the force of law, but which may be influential; and
 - providing more detailed rules, but including a prohibition on parties attempting to exploit a gap in those rules.
- 5.2 Diagram 4 at the end of this section 5 provides further detail on where these approaches have been implemented.
- 5.3 As to the issue of market participants continuing to rely on historical practices which may or may not be appropriate in the current market, we note that a limited number of regulators in the markets we have examined have attempted to address this issue, generally by affording greater discretion to themselves to determine what is or is not acceptable conduct. In particular:
- The definition of Good Broking Practice in the NZX Participant Rules provides that it is “at the discretion of NZX”. The definition further provides that:

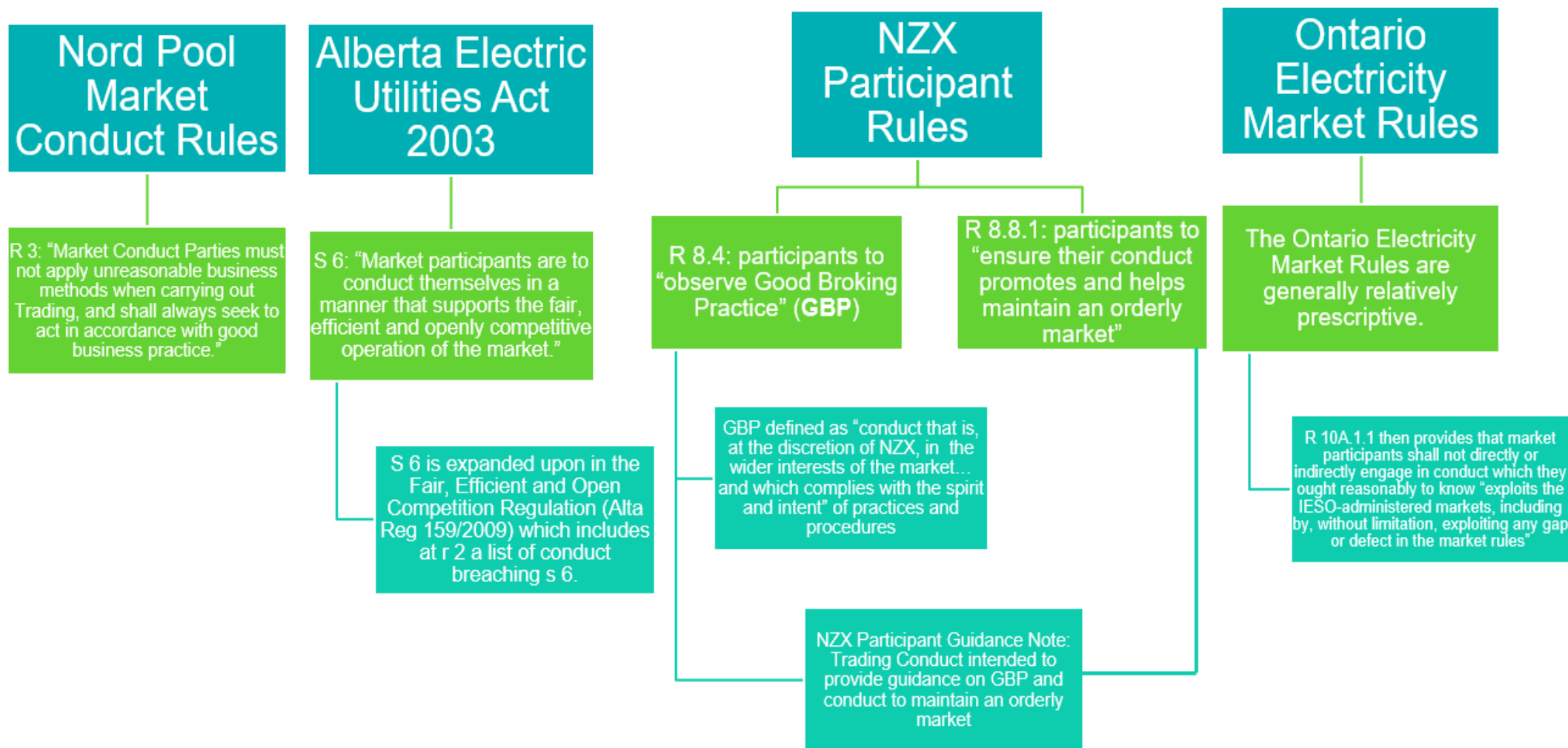
...for the avoidance of doubt, common industry practices and/or historical practices, especially in areas where no policy statement has been issued by NZX, do not necessarily constitute Good Broking Practice;
 - The European Union’s REMIT refers to “accepted market practices” as defined in Directive 2003/6/EC. That directive defines “accepted market practices” as:

...practices that are reasonably expected in one or more financial markets and are accepted by the competent authority in accordance with guidelines adopted by the Commission...

- 5.4 We trust the summary we have provided in this paper of possible comparators is useful. We would be happy to elaborate on any particular considerations or issues and to assist with next steps as required.

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Approaches to general provisions



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