FICC Markets Standards Board

Reference Price Transactions standard

for the Fixed Income markets

Final

November 2016

I Introduction

1. The FICC Markets Standards Board

The FICC Markets Standards Board ("FMSB") was established in 2015 in response to the Fair and Effective Markets Review in the UK with a mandate to issue Standards designed to improve conduct and raise standards in the wholesale Fixed Income, Commodity and Currency ("FICC") markets. The FMSB will work to build up a body of Standards over time, prioritising those areas where its Members consider there is a lack of clarity in the standards of behaviour expected of market participants, or a lack of understanding of the issues relevant to a product or transaction type, or evidence of poor conduct.

2. Applicability of FMSB Standards

When the FMSB Standards are published in their final form, they will apply to FMSB member firms. All FMSB member firms will be expected to comply, on a global basis, unless otherwise specified in the relevant Standard, with the core principles of all FMSB Standards but there may be occasions where they are unable to comply with specific details or in certain jurisdictions. In those circumstances FMSB member firms can explain their reasons for not complying.

As at the date of the publication of this Standard, some 38 firms had become members of the FMSB. Full details of those firms are available at http://www.fmsb.com. Standards will be shared with Non-Member firms and their associations, who are encouraged to adopt them. Information on Standards will be made available to users of the wholesale FICC markets (e.g. corporates and end investors) so that they may be made aware of their existence and FMSB expectation of market conduct.

3. Relationship with law and regulation

FMSB Standards do not impose legal or regulatory obligations on FMSB members, nor do they take the place of regulation. In the event of any inconsistency, applicable law, rules and regulation will prevail. In developing Standards, relevant regulators will in many cases have commented on their drafting, alongside FMSB member firms and other bodies, such that the Standards once finalized and published are intended to represent an authoritative statement of global good practices and processes.

4. Relationship with other codes

Other codes already exist in relation to certain FICC markets, or are in the process of being produced. There will be some overlap between the work of the FMSB and such other bodies and the FMSB will seek to ensure it adopts a consistent approach in cases of overlap wherever possible, and will seek to avoid issuing a Standard where the subject matter is already covered adequately by existing regulation or a code issued by another body. It may, however, draw attention to Members of an existing Code and request adoption, once appropriate steps have been taken to confirm its applicability.

5. Transparency Draft Standards

The FMSB issues "Transparency Drafts" of its proposed Standards in order to enable all FMSB members and other interested parties to comment on the proposed Standard. The normal period for comment will be indicated on the date of publication of the Transparency Draft. In the case of this Standard, this was between 30 June and 08 September, 2016.

II Reference Price Transactions

1. Explanation

This Standard aims to describe the characteristics of a transaction common in the Fixed Income markets which this Standard terms *Reference Price Transactions ("RPT")* and to set out certain expected behaviours of wholesale market participants that enter into them.

2. Scope and applicability

This Standard applies to wholesale Fixed Income markets. Although analogous transactions exist in the Currencies and Commodities markets, this Standard is limited in its application to the Fixed Income markets.

3. Description and definition – Reference Price Transaction

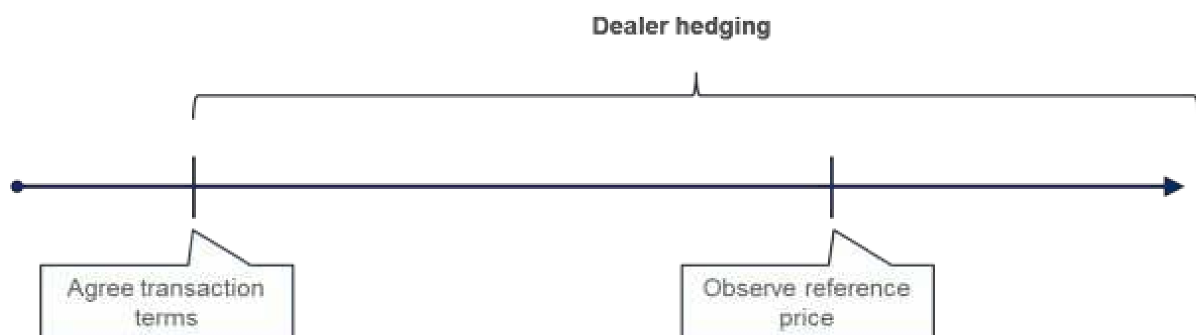
Currently in Fixed Income markets participants enter into a type of transaction known variously as a closing price order, end of day order, or reference price transaction (RPT). The common characteristic of these is as follows:

In an RPT all terms (financial instrument, buyer, seller, notional, settlement date, etc.) except the execution price, are agreed and specified at the outset of the transaction. A mechanism to determine the execution price is also agreed then, through later market observation of a reference price. (For simplicity this Standard refers to "price", though execution and reference yields are sometimes used). The later time at which this observation is taken is the *reference time*.

Sometimes in an RPT there is a liquidity taker, referred to in this Standard as the *Client* and a liquidity provider, referred to as the *Dealer*. When the Client is managing external money this Standard may distinguish between the *Asset Manager* and the underlying *Asset Owner*, the end investor who owns the assets.

Sometimes the parties agree that the *execution price* of an RPT will be the reference price itself, but in general this need not be so. For example a Dealer and a Client might agree that Dealer will sell a bond to a Client at an execution price 1c higher than the reference price.

The following timeline lays out the sequence of events in an RPT and makes clear the fact that the Dealer will in most instances be hedging its exposure under the RPT from the time the transaction terms have been agreed, and that this hedging may continue through and beyond the reference time.



4. Rationale for RPTs

Reasons reported by market participants for using RPTs include:

- **Asset Manager end of month / end of day:** Most of the main equity and bond index compilers use end-of-period closing prices in their performance calculations, and so the use of those prices in portfolio valuations and performance measurement is widespread. For this reason it is helpful for Asset Managers to transact at the index closing price when making changes to a portfolio benchmarked against an index. Trading at valuation points ensures that existing fund holders are not disadvantaged when the funds from new investors are invested;
- **Known spread:** Since the difference between the execution and reference prices are agreed upfront, some Clients use RPTs to pass risk at a predefined spread to an observable market level. (In this context spread means the difference between the reference price and the execution price, as agreed by the parties in advance);
- **Liquidity aggregation:** Liquidity can be aggregated at a pre-arranged time and venue, with RPTs employed to ensure that risk is passed at precisely that time. For example, Dealers commonly replace the interest rate exposure disappearing when cash-settled swap options expire at 11 a.m. by paying or receiving fixed to other market participants earlier in the morning via RPTs referencing the 11 a.m. ICE Swap Rate.

5. Example reference prices

Examples of a reference price include:

- An independently sourced rate, e.g. the TradeWeb mid or ICE Swap Rate;
- The average accepted bid price in a particular government bond auction;
- Closing levels for a Dealer administered index;
- The third party provided index close for a bond (for example see http://www.ftse.com/Products/mts).

6. RPTs – relationship with "orders"

This Standard does not use the term "order" to describe an RPT - in Fixed Income markets this term is often used to describe a request from a Client that a Dealer *attempt* to transact if certain conditions are met, (for example "You have an order for the next 10 minutes to buy me 50mm 10 year Bunds at 134.56 or better"). An RPT is rather a binding contract, representing a firm transfer of a certain amount of risk, at a pre-agreed "spread" from a reference price - only the execution price is determined later.[1]

7. Risks and benefits of RPTs

The nature of the RPT means that the Client eliminates uncertainty over the difference between the reference price and the execution price. Thus it might appear that the risk is passed to the Dealer at a cost equal to that difference, if any, between those two prices. However the Client (and the Asset Owner if different) bears the risk that market activity following agreement of the RPT, including any Dealer hedging of the RPT, could result in adverse price movement for the Client before the reference time.

The Dealer's risk, on the other hand, is that it is unable to hedge the RPT at the same or a better price than the execution price of the RPT and thus incurs a loss. In addition, Dealers sometimes hedge an RPT with closely related financial instruments and so in those cases

[1] It is noted that in certain circumstances national laws may define orders and that consequential obligations may arise.

must also manage the associated portfolio risk - that the instruments traded as part of the hedging strategy do not match the value of the RPT.

III Principles and Commentary

This Standard sets out a number of *Core Principles* relevant to the entering into of RPTs, together with commentary explaining their rationale.

1. Formation of the reference price

Participants should be aware of and manage the possible conflicts of interest related to the formation and observation of the reference price inherent in RPTs. Conflicts may be particularly acute if the reference price is produced by the Dealer with whom the Client has executed an RPT.

> *Core Principle 1: The possible conflicts of interest inherent to RPTs should be managed by Dealers in a way that promotes the fair treatment of Clients and other market participants.*

2. Hedging

Since an RPT entails a risk transfer, the liquidity provider of that risk (the Dealer) will at its discretion hedge that risk, and this hedging activity can take place before, during or after the reference time (as illustrated in the timeline at section II 2 above). Hedges executed before the reference time could exert market pressure on the price of the underlying instrument, and thus affect the reference price level. From a commercial perspective, the ability to hedge the RPT before the reference time means the Dealer may be able to offer the Client a lower spread than would otherwise be the case.

The possibility of market pressure arising from Dealer risk management activity, and the related potential conflict of interest between the Client and the Dealer, is the key characteristic of RPTs which creates the need for well understood standards for their execution and hedging.

> *Core Principle 2: Dealers should ensure that the Client is aware of the key mechanics of RPTs, in particular the fact that hedging can take place before, during or after the reference time, by making clear in its terms of business or otherwise by disclosure to the Client that the Dealer observes FMSB Standards, or by express disclosure in some other way.*

A Dealer should have regard to the effect its hedging of an RPT might have on the reference price and should balance the objectives of its hedging strategy against the possibility of putting undue pressure on the reference price, recognising that some price pressure is to be expected as risk is passed, particularly for large transactions or transactions in less liquid markets.

Core Principle 3: Dealers should ensure that their hedging is solely aimed at risk mitigation and is never performed for the purpose of influencing or manipulating the reference price.

Specific factors to be considered in determining whether hedging practices are acceptable or not include:

- Hedging should generally be at a pace consistent with normal market volumes at that time of day in the relevant instrument (adjusted as necessary for the volume implicit in the RPT itself, and recognizing that this may not be possible for illiquid instruments);
- Hedging should be designed to neutralize the risk of the Dealer portfolio (including all its RPTs), and should not be undertaken for the purpose of creating a new significant open risk position;
- Although volatility can be due to many factors, a reasonable hedging strategy would not be expected to induce materially higher volatility of the reference price around the reference time, taking into account the size of the risk being transferred;
- Intentional over-hedging (i.e. hedging more than required to cover the firm's risk) should not take place other than where that is a necessary consequence of appropriate hedging activity, such as where the relevant hedging instrument is only available in a size greater than that required to hedge the RPT.

Very often dealers are fielding other client transactions, or are managing their own risk during the hedging time frame of an RPT, and all these activities are usually done on a portfolio basis. It is therefore not required, and indeed would sometimes be difficult, to assign individual hedging transactions to individual RPTs. Nonetheless Dealers should ensure that the management of their aggregate positions is consistent with this Standard.

Core Principle 4: Where hedging takes place at a portfolio level Dealers should ensure that the management of their aggregate positions is consistent with this Standard.

3. Client activity

Core Principle 5: Clients should not execute RPTs for the purpose of ultimately influencing the reference price, and should not attempt to influence the reference price during the hedging window.

When evaluating Dealer performance, or considering the efficacy of RPTs in general, Clients should consider the effect of hedging activity on the reference price.

4. Restrictions on dissemination of information

Information regarding an RPT (whether pending or executed) or its associated hedging must be treated as confidential and must not be disclosed externally. This Standard does not, however, prevent Dealers from satisfying reporting requirements, disclosing details of an RPT to the extent necessary for execution, processing or settlement of that RPT, or from distributing appropriately aggregated and anonymised market colour provided such distribution does not negatively impact their client's pending RPTs.

Internal disclosure must not result in another part of the Dealer firm profiting inappropriately.

The Dealer may offset the risk implicit in an RPT with other Client transactions, the Dealer's own inventory or in the wholesale market but must keep details of the RPT confidential while so doing.

> *Core Principle 6: Information about an RPT should not be shared externally and only shared internally on a need to know basis, the policy for which should be documented.*

5. Monitoring, Controls and Training

> *Core Principle 7: Dealers should implement processes and record keeping to monitor RPTs to ensure compliance with this Standard. The systems should include an escalation process for addressing concerns identified by traders or their supervisors in connection with the trading and hedging of RPTs.*

> *Core Principle 8: Firms should ensure that their personnel have been trained on the substance of this Standard and their responsibility to identify and escalate suspicious transactions internally.*