The Securities and Futures Commission
54/F, One Island East
18 Westlands Road
Quarry Bay, Hong Kong
(*Submitted by e-mail to* *ECM_DCM_consultation@sfc.hk*)

7 May 2021

Dear Sir/Madam,

HK SFC - Consultation on the Proposed Code of Conduct on Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions

The International Capital Market Association (ICMA) welcomes the opportunity to engage with the SFC regarding this consultation.

ICMA promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. It is a not-for-profit membership association with offices in Zurich, London, Paris, Brussels, and Hong Kong, serving around 600 member firms in 60 countries. Among its members are private and official sector issuers, banks, broker-dealers, asset managers, pension funds, insurance companies, market infrastructure providers, central banks & law firms. It provides industry-driven standards and recommendations, prioritising four core fixed income market areas: primary, secondary, repo & collateral and sustainable finance. ICMA works with regulatory and governmental authorities, helping to ensure that financial regulation supports stable and efficient capital markets. www.icmagroup.org

This response is focused on the debt capital markets, and reflects the views of ICMA's wider global membership, including intermediaries, investors, and issuers.

Our specific recommendations in this response have been informed mainly by ICMA's primary market constituency, which is comprised of underwriters that lead-manage cross-border syndicated DCM transactions throughout Asia-Pacific and beyond. This constituency deliberates principally through:

- the ICMA Asia Pacific Bond Syndicate Forum, which gathers the senior members of such lead-managers' syndicate desks; and
- the ICMA Asia Pacific Legal & Documentation Forum, which gathers the senior members of such lead-managers' legal documentation and transaction management teams.

ICMA would be pleased to discuss its response at SFC's convenience.

Yours faithfully,

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Background and executive summary

International DCM primary market background

The bond and equity markets are different in important ways. Given the differences in market structure and market dynamics, the practices followed in bookbuilding and placing new issues of bonds necessarily differ from those employed for IPOs and other equity primary market transactions.

ICMA has, for more than 50 years, sought to promulgate best practices and publish market guidance in the cross-border debt primary markets, chiefly through industry committees and the ICMA Primary Market Handbook.

ICMA has published extensive background on current practices in bond syndication in the international markets. The three below may be particularly useful to the SFC.

(A) ICMA's February 2020 response to IOSCO sets out a description of DCM primary market practice, drawn mainly from European cross-border markets but broadly consistent with current Asia practice. This includes an outline of typical deal flow as well as detailed practical information on investor meetings, pre-sounding, bookbuilding and allocation.

(B) Detail on the "pot" (shared) order book structure is set out in Annex 1 to this response and a comparison with the previously more common "retention" structure (still used in the domestic Chinese and Swiss franc markets) is set out in a December 2000 article (*Why do the all the top banks advocate Pot?*) in *The Treasurer* magazine.

(C) The recent ICMA podcast *"Whatever Happened to Underwriting?"* is a short and useful narrative of how DCM primary market practices have evolved over the past few decades.

Objectives of market reforms

ICMA understands the SFC ultimately aims to address certain concerns.

(A) Bookbuilding for new issuance executed out of Hong Kong would benefit from more consistent standards of governance and more rigorous expectations for conduct.

(B) This is primarily due to certain issuers (who often are beyond the SFC's direct regulatory jurisdiction in this respect) adopting more fluid incentive structures. Issuers may appoint large underwriter syndicates and change the syndicate membership and their roles during the execution of a deal. Issuers may also leave remuneration undecided until after the pricing or closing of a transaction.

(C) The nature of such syndicate structures can create incentives for intermediaries (and ultimately behaviour) inconsistent with international DCM accepted market practice standards.

ICMA understands and appreciates these concerns. We support measures that encourage leadership and deliver accountability, whilst also enabling Hong Kong to continue to thrive as a principal market for origination and execution of international DCM issuance.

ICMA's views on the text of the proposed Code

The unanimous view of ICMA's membership is that the requirements would become substantially clearer if they were set out in distinct ECM and DCM sections.

From a substantive point of view, ECM and DCM primary markets generally follow quite different practices, involve different types of investors, and pose different challenges in terms of the dynamics between issuers and intermediaries. While ICMA and its members support the SFC's efforts to improve fairness and efficiency in both markets, we believe that DCM transactions should not fall under the same regulations as ECM transactions.

If the proposed Code is to cover both ECM and DCM transactions, ICMA's members believe that the new rules should minimise ambiguity, with explicit guidance as to which rules apply to different types of transactions and products. In particular, given the potentially broad impact of the proposed Code, we would request as much clarity as possible whether and how specific provisions of the Code apply to DCM transactions. This would greatly help the industry in practical implementation of the proposed Code.

There may also be value in reviewing the relevant legal texts of those jurisdictions whose regulations formed the main basis behind the recommendations in IOSCO's September 2020 Final Report *Conflicts of interest and associated conduct risks during the debt capital raising process*.

Summary of key ICMA positions on the proposed Code

In general, ICMA agrees with the proposed reforms to the extent they:

1. Require early appointment of syndicates and early determination of fees
2. Prohibit X-accounts
3. Prevent inflated orders
4. Restrict rebates

In general, ICMA would recommend modifications to the proposed Code in the following areas:

1. The scope of the proposed Code as it applies to DCM, which in its current form can lead to inconsistent practices in international transactions and potential regulatory arbitrage.
2. The roles and responsibilities of OCs and CMIs, in particular that (a) the OC should not be obligated to provide advice to the issuer on syndicate membership and fee arrangements, and (b) OCs and CMIs should be responsible only for their own conduct and not for the conduct of others in the syndicate.
3. The definition of proprietary orders, which we believe should not include arm's length, public-side intra-group orders.

Response to consultation questions

Question 1: Do you consider the definitions of "bookbuilding activities" and "placing activities" to be clear and sufficient to cover key capital raising activities? If not, please explain.

The definition of "bookbuilding" is clear and sufficient.

The definition of "placing" can be open to interpretation. As defined in the Consultation, "placing activities" could be seen as merely the final, operational settlement stage of "bookbuilding activities". On the other hand, in the DCM market, "placing" is often understood as a wider activity that actually includes bookbuilding.

For purposes of the Code, ICMA would recommend that "placing" be clarified to include obtaining external orders and submitting external or internal orders to the order book.

Regardless of the definitions ultimately used, ICMA consensus is that a proper definition would cover any staff (notably sales) involved with the marketing and selling of bond new issues.

Question 2: Do you agree with the proposed scope of coverage for both ECM and DCM activities?

ICMA has had lengthy discussions with intermediaries and investors on how the Code might apply to DCM. While the DCM criteria themselves are readily understood, their application to DCM is problematic due to the cross-border nature of most DCM transactions involving Hong Kong.

We do not comment on the proposed scope for ECM, except to highlight that the Code's practical application is far clearer—namely, ECM transactions where issuers have, or seek to have, their equity listed in Hong Kong.

Unintended consequences

For DCM, we understand that the Code applies when all three of the following criteria are satisfied:

- i) persons licenced by and registered with the SFC;
- ii) engage in bookbuilding and/or placing activities (as defined further in the Code); and
- iii) this takes place in Hong Kong.

Although the DCM criteria themselves are clear, their application to the global, cross-border DCM market will result in anomalous outcomes.

1. In many international DCM transactions, the Code will apply to some intermediaries and not apply to others within the same syndicate. (For example, one syndicate member may be based in Hong Kong, and another syndicate member may be based outside Hong Kong with no distribution to investors in Hong Kong.)

2. Also, within the same intermediary involved in a DCM transaction, the Code will apply to some employees and not apply to others. (For example, a senior head of syndicate may be based outside of Hong Kong while a colleague from the sales team on the same transaction may be located in Hong Kong.)

Either situation will cause compliance uncertainty. There will be a risk of inconsistent practices on the same transaction between firms and within firms.

To give just one concrete example, the Code would require prior confirmation of all appointed syndicate members, and their roles and remuneration. But issuers would not themselves be obligated to do this with respect to the out-of-scope intermediaries in mixed syndicates. The same inconsistent practices could arise in other respects, for example regarding the Code's treatment of rebates, X accounts and internal orders.

In-scope intermediaries will not be able to compel the out-of-scope members in mixed syndicates also to adhere to the Code as if they were subject to it. And, in reality, it cannot be assured that in-scope intermediaries will be able to persuade issuers to require that out-of-scope intermediaries follow the practices required by the Code.

Also, significantly, the Code will (perhaps inadvertently) capture many cross-border transactions with only a very limited connection to Hong Kong. For example, European or US issuers frequently engage in large multi-national debt offerings where only a modest proportion of the issuance is placed into Hong Kong. Similarly, certain regional local currency issuers may engage Hong Kong based syndicates on transactions with little or no placement of the issuance into Hong Kong. For both issuers and intermediaries, the effort and disruption involved in ensuring compliance with the Code—for a relatively small portion of deal's overall placement—may not be worth the benefits of including Hong Kong investors.

Risks of regulatory arbitrage

Thus, the currently proposed Code, applied in the context of current market practices, will likely create the incentive for regulatory arbitrage. For example, it may cause borrowers or underwriters in a DCM transaction to seek to:

- avoid Hong Kong as a centre of DCM execution,
- avoid Hong Kong investors in the distribution of the offering and/or
- avoid involving Hong Kong-based staff in bookbuilding or placing activities.

Potential solutions

Bright line rule

One way to mitigate these risks would be to adopt different, more "bright line" DCM scope criteria, similar to what is proposed for ECM.

We could recommend that the code should apply to DCM only if:

i) the new debt issue is to be listed in Hong Kong, and/or
ii) the DCM issuer (or guarantor) has its equity listed in Hong Kong, and/or
iii) the issuing or parent entity is incorporated in Hong Kong.

ICMA stakeholders would be open to other criteria that, similar to ECM, are based on easily determinable characteristics of the issuer. We recommend these issuer-based criteria for the purpose of clarity in implementation, and we reiterate that, as a matter of policy, ICMA's overall membership (including intermediaries and investors) fully supports the Code's application in practice to transactions principally executed in Hong Kong.

This bright-line rule could be implemented on a trial basis (or as a first phase of a full implementation), and then studied to assess whether the criteria are wide enough to cover transactions where undesirable conduct is taking place.

<u>Phase-in period</u>

Another way to manage the potential risks is to phase in some of the provisions of the proposed Code that might cause difficulties if the applied scope is inconsistent in practice.

For example, with respect to DCM, the proposed Code's provisions regarding CMIs only could be implemented and enforceable first; then the provisions on OCs could start to apply at a later date after a market impact assessment.

Equity-linked bonds

There is some uncertainty among ICMA members whether equity-linked debt, namely convertible and exchangeable bonds, should fall under the DCM or ECM parts of the Code, as many of our members conduct their equity-linked bond businesses as part of their ECM business.

ICMA would be pleased to discuss further with the SFC the appropriate treatment and practices related to these securities.

Question 3: Do you consider the role of an OC to be properly defined? If not, please explain.

ICMA has no major objection to the definition of the DCM OC role, as set out in paragraph 53(b) of the Consultation.

> *In the case of a debt offering, an OC is a syndicate CMI which, solely or jointly, conducts the overall management of the debt offering, coordinates, the bookbuilding or placing activities conducted by other CMIs, exercises control over bookbuilding activities and makes pricing or allocation recommendations to the issuer.*

Ultimately, as explained in the Consultation, the OCs would be defined "by reference to the activities they actually carry out rather than by their titles". This approach is sensible and properly takes into account the fact that the titles given in a transaction may not clearly reflect what the intermediaries actually do in a transaction.

The proposed distinction between OC and syndicate CMI generally reflects current DCM market practice on the division of roles. ICMA is however unclear about the concept of "non-syndicate" CMI's, as such firms would not be acting for the issuer in any formal capacity. There is no concept analogous to "non-syndicate CMI" in international DCM practice. In particular, ICMA members believe that private banks and private wealth management entities should not be considered as non-syndicate

CMIs, as they are acting on behalf of their private banking clients, and not acting as selling agents for the issuer or other CMIs.

What is ultimately important to ICMA, though, is that the subsequent *responsibilities and obligations* of OCs (and CMIs) are reasonable and feasible to carry out. We address these in more detail under the relevant Questions 4–18 below.

We would like to emphasise that the most important point for ICMA is that the OC should *not* be obligated to provide advice to the issuer on syndicate membership and fee arrangements. This is considered to be a conflict of interest in other regulated markets. Furthermore, our view is that the OC should *not* be responsible for the conduct of other CMIs and each CMI must be responsible only for its own conduct and compliance with the proposed Code.

The view of ICMA members is that syndicates should be allowed to use the specific titles they choose according to market convention (not necessarily "Overall Coordinator" and "Capital Market Intermediary") in relevant marketing documents and disclosure.

Question 4: Do you agree that the appointments of OCs and other CMIs and the determination of their roles, responsibilities and fee arrangements, should all take place at an early stage? If not, please explain.

ICMA fully supports the SFC's proposals to improve clarity on syndicate roles and responsibilities. In particular, ICMA strongly supports early appointment of all syndicate members,[1] early confirmation of their individual roles, and early confirmation of their individual share of the "fixed" element of overall syndicate remuneration.

Appointment of OCs and CMIs

ICMA's members, including intermediaries and investors, strongly agree the issuer should confirm these appointments as early as possible. The consensus view is that if there is to be a specific point in time in the Code, the appointments should be required before the *public announcement*[2] of the proposed transaction (defined as the *de facto* conveyance of information to the market, for example, through Bloomberg). It seems SFC-licensed and registered entities would effectively only be permitted to accept an issuer mandate to participate in syndicates to the extent the issuer complies with these requirements in the Code. We would also recommend clarification in the Code that pre-announcement activities, such as investor meetings, should not require formal appointment.

[1] The relevant recommendation of the ICMA Primary Market Handbook is:

Recommendation 3.2 The appointment of a bookrunner may happen earlier than the appointment of other joint lead managers, so, where possible, such other joint lead managers should be:

(a) notified of their appointment and provided with draft documentation at least 48 hours (two business days) prior to the announcement of the transaction to allow them to familiarise themselves with the proposed transaction and related documentation and allow any necessary internal approvals to be obtained […].

A bookrunner should explain the rationale for this to the issuer.

[2] As a point of clarification, the consultation references to "launch" seem to refer to the initial announcement (as "launch" in a DCM context means a subsequent announcement, following fixing of the of final spread at the end of bookbuilding). ICMA suggests using "announcement" in the proposed code as terminology consistent with international DCM practice.

This confirmation would likely be done in written electronic form, since many bond transactions are mandated on extremely short notice. While we strongly support the early appointment of banks and determination of the fee in writing at the time of appointment, granular decisions on logistics (especially those requiring coordination among all syndicate members) should not be required to be included in this confirmation.

The view of ICMA members is that syndicates should, if they choose, be allowed not to use the specific titles “Overall Coordinator” and “Capital Market Intermediary” in relevant contracts and transaction disclosure. In any case, the roles and general responsibilities would be set out in the confirmation of appointment.

Related to this point, since the concept of OC and CMI does not exist in any other jurisdiction, this could raise again potential risks of inconsistent application of scope. For example, in the case where all transaction lead managers are out of scope but only one CMI is in scope, an issuer may not be able to (or wish to) appoint the in-scope CMI earlier than others in the transaction. This may effectively prevent the in-scope syndicates from participating in a global offering.

General responsibilities of OCs and CMIs

ICMA’s members strongly disagree that any debt syndicate member should or actually can be responsible for any other syndicate member. Each CMI should remain responsible exclusively for its own appointment to the syndicate, for its own risk position, and for its own conduct. In particular, each CMI would remain responsible only for its own issuer assessment[3] and its own investor assessment and compliance with selling restrictions.

OCs would of course coordinate on submitting pricing and allocation recommendations to issuers.

OCs may also be properly required to provide information about the issuer to other CMIs, as long as this is limited to information related to the offering (such as the draft termsheet and offering documents, announcements, and book messages to the extent not already public). OCs should not be required to provide broader background due diligence, as this should be each CMI’s responsibility.

Also, as explained further under Question 5, ICMA members would recommend clarification in the Code that the OC is not required or expected formally to advise the issuer. OCs do not act in the capacity of a “financial advisor” or as fiduciary or agent to issuers; therefore, they do not give issuers advice in the legal sense.

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[3] The ICMA Primary Market Handbook Recommendations relating to due diligence are set out below:
Invitation to join transactions

R3.2 The appointment of a bookrunner may happen earlier than the appointment of other joint lead managers, so, where possible, such other joint lead managers should be: […]

(b) invited to participate in any transaction due diligence calls.

A bookrunner should explain the rationale for this to the issuer.

Due diligence

R3.3 The appropriate level of due diligence to be performed in the context of each issue should be considered carefully.

3.4 It is impossible to prescribe whether or what due diligence procedures would be appropriate in the circumstances of each issue, and procedures will vary greatly from issue to issue (depending, for example, on the type of securities being issued, the rights attached to those securities and the nature of the issuer and its business).

Advice on syndicate composition and fees

ICMA's view is that OCs would be conflicted from advising issuers on other syndicate member appointments and remuneration. Furthermore, OCs cannot (and should not be obligated to) manage the risk or police the conduct of other syndicate members.

The relationship among syndicate members in major DCM markets is long established to be that each member deals with the other on an arm's length principal basis only. The rights and obligations among syndicate members is set out in an Agreement Among Managers entered into for each transaction. Changing these roles imposing agent like obligations on some syndicate members to other members would alter this allocation of liability and likely be disruptive to syndicate formation.

Fixed and discretionary fees; timing of payment

Intermediaries and investors in ICMA's membership agree that a substantial majority, if not the entirety, of overall syndicate remuneration should be represented by the 'fixed' element. Indeed, discretionary remuneration is relatively rare in international DCM practice and, when it occurs, typically represents around 10% of overall remuneration.

We suggest fees should be deducted including any discretionary element from the gross issue proceeds at settlement. This would be in line with international DCM accepted practice.

Question 5: Do you agree that an OC should provide advice to the issuer on: (i) syndicate membership and fee arrangements; (ii) marketing strategy; and (iii) pricing and allocation? If not, please explain. What else should the OC advise the issuer about?

Advice on syndicate membership and fees

No, ICMA believes that it would create a clear conflict of interest for OCs to advise issuers on other syndicate member appointments and remuneration. When it comes to who is on the transaction and how much they are paid, the commercial and competitive interest of each OC may not be aligned with that of the issuer.

Advice on marketing strategy

Yes, the OC should provide market guidance, and discuss this and related matters with the issuer (to the extent there is indeed a "marketing" phase) and then act according to borrower needs and requirements. However, it is important to clarify that OCs do not give issuers advice in the legal sense. In certain IPO and other ECM transactions, issuers may hire a financial advisor for the transaction that is not a member of the syndicate.

Advice on pricing and allocation

Yes, in general, with respect to pricing and allocation, the OC should confer and discuss with the issuer. However, the OC should only have a responsibility to provide its good faith views on the appropriate pricing level for the transaction. We would welcome clarification from the SFC that the OC is not required or expected formally to advise the issuer on pricing and allocation. We also note that, with respect to allocation, some issuers may choose to allocate entirely themselves, with OCs then providing only a limited book management service. Some issuers may also make their own decisions on pricing without substantively consulting with the syndicate banks.

Question 6: Do you agree that a private bank should not pass on to investor clients any rebates provided by the issuer? If not, please explain.

ICMA members' consensus view, though not unanimous, is that rebates can be permitted where these will not be passed on to beneficial owners to avoid end investors receiving different prices, provided also that the recipient keeping the rebate is not in breach of its fiduciary obligations to its clients.

However, it is important to note that syndicate members cannot in practice, and should not be obligated to, police the conduct of a private bank (or, for that matter, other CMIs within the syndicate). It is the obligation of the recipient of a rebate to comply with its own fiduciary obligations as well as the proposed Code and other applicable regulations.

We also reiterate that the Code's scope, applied to DCM, could be problematic in the context of rebates. If the Code is not consistently applied across the syndicate, or if private banks in other jurisdictions are subject to different rules, there may effectively still be preferential treatment among investors. Moreover, it is the view of some ICMA members that a prohibition on private bank rebates for transactions covered by the Code could further exacerbate the regulatory arbitrage risk discussed in our response to Question 2 above.

We note that some ICMA members are of the view that rebates to private banks should be prohibited entirely, for the reasons that such a prohibition would more effectively reduce the risk of inconsistent pricing to end-investors, and would not materially reduce demand.

Question 7: Do you agree that an OC should provide relevant information to CMIs to enable them to identify investor clients which are Restricted Investors in share offerings or have associations with the issuer in debt offerings? If not, please explain.

The consensus view of ICMA members is that the Code should not impose an obligation on OCs to provide such information to other CMIs.

A more fundamental point is that the issuer, not the OCs or other CMIs, is in the best position to know which investor entities may be closely associated with it (particularly when orders are referred by the issuer itself). If any institution is ultimately required to provide any confirmations regarding associated entities, ICMA would suggest that the obligation should rest on the issuer itself. Any obligation on the part of intermediaries to ascertain associated investors should be discharged simply by asking the issuer.

ICMA would also recommend that the definition of "associations" as applied to DCM be clarified in the Code. ICMA would be pleased to consult further on the overall appropriate definitions in the assessment of DCM investor clients.

Question 8: Do you agree that information about the underlying investors should be provided to an OC by CMIs placing orders on an omnibus basis when they place orders in the order book? If not, please explain.

“Omnibus order” is not a term used in DCM markets. We would recommend a precise definition of the term if it is used in the final version of the proposed Code.

If “omnibus” refers to orders from private banks (that are in turn placing orders on behalf of multiple end-investors) or an institutional fund manager (that is placing a consolidated order for multiple underlying funds), then such combined orders are consistent with accepted international DCM practice—as the banks face such institutions as investors themselves. We believe there should be no obligation for private banks or fund managers to be transparent on the identity of their end private bank clients or underlying funds placing orders.

However, if “omnibus” means an order placed by one of the syndicate banks, which is formed by consolidating multiple undisclosed end-investor orders, then we would agree that information about the end-investors should be provided to the OCs. Omnibus orders understood this way would in practice be the same as “X accounts”, which ICMA members would strongly support prohibiting (see Question 12). Also, combining investor orders reduces the transparency of the order book for both the syndicate banks and the issuer, making it difficult to make accurate recommendations on allocation.

Question 9: Do you think there would be difficulties in a large IPO or debt offering for OCs to remove duplicated orders and identify irregular or unusual orders in the order book? If so, please provide examples.

In general, no.

Syndicates always strive to avoid or address order duplication and our members believe this is not a major issue in transactions. Centralised order management platforms can help, to the extent that investor orders are entered into these platforms (this is common in the market). Also, a ban on X-orders will make it easier for syndicates to identify investors and avoid duplication.

Syndicates always seek to identify irregular or unusual orders. However, 100% elimination cannot be guaranteed.

Question 10: Do you agree that OCs and CMIs should not accept knowingly inflated orders? If not, please explain.

Yes.

Orders that are known to syndicate members to be inflated should not be accepted into order books. This is consistent with international DCM accepted practice standards and the ICMA Primary Market Handbook.[4]

With respect to inflated orders, we would like to reiterate our general position that that the OC should not be responsible for the conduct of other CMIs, and that each CMI must be responsible for its own conduct and compliance with the proposed Code.

Question 11: Do you agree that OCs should ensure the transparency of the order book? If not, please explain.

ICMA agrees that the order book should be made transparent to *issuers*. Issuers are entitled to choose who is buying their bonds pursuant to their offer and so they should have access to order books. We note, however, that OCs can ensure book transparency to the issuer only to the extent that the orders they receive are transparent to them.

No compulsory book updates

We would request clarification as to what extent the proposed Code would require book updates to investors and the public. ICMA does *not* recommend mandating compulsory book updates, but maintains that the order book should be transparent to issuers.

- Investors' knowledge of book status should not serve as the basis for investment decisions, which should rather be driven by issuer and transaction fundamentals. This is explained further in the ICMA Primary Market Handbook.[5]
- Order books may sometimes demonstrate insufficiently clear momentum or outcome for active syndicate members to be able to conclude that disclosure would be clear, fair and not

[4] **Appendix A12** // **Pre-sounding, bookbuilding and allocations**

15. […] An investor might place an order larger than its true internal demand (order 'inflation') if, for example, it (i) anticipates that its order will be reduced on allocation because of oversubscription, (ii) overestimates demand that it was unable to confirm internally prior to placing its order, or even (iii) anticipates particularly strong demand by other investors and so expects to liquidate part of its allocation in initial secondary trading to crystallise the initial issuance premium ('flipping'). In this respect, it seems that some investors are unable or do not wish to inflate their orders, others appear to do so frequently, and yet others may do so just occasionally according to market conditions. Leaving aside how order inflation might be treated under applicable market abuse regulations, bookrunners may well apply a discount factor to, or even entirely exclude on allocation, orders they view as being potentially inflated (bookrunner views in this respect will *inter alia* account for previous experience with specific investors). Investor transparency to bookrunners is an important factor in avoiding mischaracterisation in this respect. In particular, investors may find it helpful to explain orders that (i) appear to be out of proportion compared to orders on previous transactions or to apparent assets under management, or (ii) are placed or increased at a relatively late stage during the launch process (and so appear to be based on perceived levels of demand rather than on transaction fundamentals). This later aspect is further complicated in that delayed demand may be due, as mentioned above, to investors legitimately needing to confer internally with colleagues managing sub-funds.

[5] **Appendix A12** // **Pre-sounding, bookbuilding and allocations**

19. Investors should, and generally do, make their investment decisions on the basis of transaction 'fundamentals' (i.e. the issuer's business and the proposed terms of the issue) rather than 'technicals' (e.g. demand from other investors). Some investors may have understandable reasons for wanting to know levels of demand, and so seek disclosure of orderbook status. However, some investors also seek such information in order to magnify their orders where there is substantial oversubscription and so to improve the likelihood of securing individual allocations that, albeit reduced because of the oversubscription, match their true underlying demand (see further above on inflation of orders and principles of allocation).

misleading as required by law (and allowing for X orders and omnibus orders could be particularly difficult).

- Mandatory order book transparency would increase execution risk and the potential for failed pricing, especially in volatile market conditions.
- Mandatory book updates are not a feature of any major international market, so the proposed Code (to the extent it requires book updates) could increase the risks related to scope addressed in Question 2.

Recommendations for transparency of order book

If book status is disclosed at all, it is important that the disclosure be accurate, not misleading, and generally consistent at various stages in the bookbuilding process. This is accepted international DCM practice as outlined in the ICMA Primary Market Handbook.[6]

ICMA, following extensive discussions with its Asia-Pacific primary market committees, published a basis for book disclosure for Asia-Pacific transactions in the ICMA Primary Market Handbook.[7]

This provides that public disclosures of book status (if any):

(a) include bookrunner treasury / ALM and arm's length trading desk orders, but in a separate category from other investor orders;

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[6] **Book disclosure**

Recommendation 5.13 For a pot deal, any disclosure of investor demand should:

(a) be agreed by the bookrunners in advance of being made (to help compliance with disclosure being required by law to be clear, fair and not misleading and so being representative of investor demand) […].
Appendix A12 // **Pre-sounding, bookbuilding and allocations**

20. Though individual bookrunners try to manage investor expectations whilst orderbooks are open, ultimately they will collectively agree, in the circumstances of individual transactions, what degree of disclosure is appropriate to be made before publicly disseminating it. This is reflected in ICMA Recommendation R5.13. Any such disclosure is required by law to be clear, fair and not misleading and issuers and bookrunners focus on ensuring any disclosure is representative of investor demand. This may result in a conclusion in individual cases that no information relating to the orderbook should be disclosed before the book closes. Distinctly, bookrunners may also seek (as one mitigant to order inflation) to limit disclosure of book size to just whether transactions are subscribed or not, without stating the scale of any oversubscription.

[7] **Book disclosure**

Recommendation 5.13B Where a book update is stated as being in accordance with "ICMA 5.13B" (anticipated to be in an Asia context), this means:

(a) any orders from bookrunner internal treasury / balance sheet management and arm's length trading desk orders (in line with typical trading desk sizes) were (if material in aggregate) included in the book update under a segregated heading of bookrunner demand;

(b) any bookrunner backstop positions, trading desk orders specifically requested by issuers and/or syndicate and orders from DCM/syndicate desks (regardless of approvals received) were (if material in aggregate) not included in any form in the book update (even under any segregated heading of bookrunner demand);

(c) any orders from a bookrunner's different desk constituents were split out into component parts to enable appropriate classification;

(d) any orders known, or reasonably suspected (in line with internal escalation requirements), to be inflated were not included in the book update;

(e) orders (whether 'account X' orders or otherwise) were entered into the orderbook as a single, separate line item for each third party investor order;

(f) all third party investor orders were entered into the orderbook either (as appropriate) under their own name or as 'account X'.

(b) exclude any bookrunner backstop positions and solicited trading desk orders; and

(c) include distinct order book entries for any individual X orders.

Question 12: Do you agree that "X-orders" should be prohibited? If not, please explain.

X orders

ICMA's stakeholder majority view, reflecting both intermediaries and investors, is that X orders should be prohibited.

In the current market, some ICMA members note the legitimate need for occasional "account X" orders on a rare basis, and support their continued limited use. However, overuse of X orders can make effective allocation difficult—or impossible—where orders are allocated out a of single shared "pot" order book. The ICMA Primary Handbook currently reflects this limited use as well as the potential problems.[8] We note also, relevant to Question 9, that a prohibition on X-orders will make it easier to identify and manage duplicated orders.

Omnibus orders

As noted under Question 8, "Omnibus" orders are not generally recognised in international DCM practice and we would recommend clarification of the term in the DCM context. If "omnibus" means an order placed by one of the syndicate banks, which is formed by combining undisclosed investor orders, then this would effectively operate the same as "X accounts".

Question 13: Do you agree that OCs and CMIs should be required to establish and implement allocation policies? If not, please explain.

ICMA is supportive of robust allocation policies at the institutional level.

Underwriter allocation policies are, in terms of accepted international DCM practice standards, common practice and substantively similar. These policies are specific to each intermediary and reflect "generic" borrower interest. Underwriter allocation policies are not specific to individual borrowers or individual transactions.

[8] **Name give-up**

Recommendation 5.7A For a pot deal, issuers should be notified of the identities of any investors entered into the orderbook as 'account X'.

5.7B X accounts enable the few investors facing exceptional confidentiality constraints to participate in transactions. However, they limit orderbook transparency to bookrunners. So, beyond certain minimal levels, they can complicate bookrunners' ability to (i) accurately disclose investor demand (see R5.13) or (ii) deliver effective allocation/pricing recommendations to their issuer clients. Furthermore, only issuers have the ability to review X accounts to reconcile duplicate and split orders.

5.8 Under the laws of some countries such information may be regarded as being confidential and its disclosure may only be made with the prior consent of the customer concerned.

In a transaction, the active syndicate members will seek to identify any specific issuer preferences (both explicitly stated and implicitly understood) and then refer to the commonalities in their institutional allocation policies in order to define a specific allocation strategy and priorities for the transaction. The ICMA Primary Market Handbook includes guidelines to this effect.[9]

ICMA would like to emphasise that although allocation policies are generally similar in the international DCM context, banks should be able to formulate and maintain their own policies.

Question 14: Do you agree that client orders must have priority over proprietary orders at all times? If not, please explain.

ICMA's view is that the SFC's proposals on internal orders (also known as "intra-group orders") should be more nuanced.

We and our members distinguish three types of intra-group orders in the DCM primary context:

- Orders from syndicate members' asset management arms
- Orders from syndicate members' treasury / asset & liability management / balance sheet management functions
- Orders from syndicate members' trading desks.

In actual practice, internal orders in the first two categories may, in certain transactions managed from Hong Kong, constitute a substantial proportion of demand from long-term "buy and hold" investors. For such orders, equal treatment with similar orders from outside the syndicate is considered to be fair and appropriate treatment, and consistent with accepted international DCM practice. This is distinct from ECM, because unlike with equity, many banks have treasury functions which have a legitimate need to buy and hold certain types of bonds as part of their balance sheet management efforts.

On the other hand, trading desk orders (both external and internal) are generally subject to a lower allocation priority in international DCM practice.

ICMA would recommend that, from a regulatory perspective, syndicate members' intra-group orders that are placed on an *arm's length basis* (unsolicited, with the order having no associated economic benefit, cost or risk to the syndicate desk itself) should be treated *pari passu* with similar orders from outside the syndicate. In other words, these internal, arm's length orders should be treated equally in terms of pricing relevance and allocation criteria, and not be disadvantaged or unfairly treated merely by virtue of the DCM department of the bank being engaged as an underwriter.

[9] **Allocation priorities of issuers**

Recommendation 5.9 Specific issuer allocation interests or priorities (or related broad guidelines), if any, should be obtained at the earliest opportunity, and at least prior to draft allocations being presented to the issuer for discussion.

Appendix A12 // Pre-sounding, bookbuilding and allocations

17. […] Bookrunners make an allocation proposal to the issuer based on (i) their internal allocation policies developed in relation to their understanding of generic issuer interests (notably such as those outlined above) and (ii) any specific issuer interests/priorities explicitly communicated by the issuer (including pursuant to ICMA Recommendation R5.9) or otherwise arising from the bookrunners' understanding of the issuer's activities. […]

Specifically, ICMA would recommend that the SFC clarify the definition of "proprietary order" in the Code to exclude unsolicited, arm's length orders, with the order having no associated economic benefit, cost or risk to the syndicate desk itself.

Of course, ICMA recognises that internal, arm's length orders will not present a conflict of interest only if there are adequate institutional information barriers between the private and public sides, and other relevant safeguards within the syndicate banks. Incidentally, internal investors on the public side should not have access to the order book and should not be privy to non-public information. ICMA member banks take these requirements seriously and ICMA would recommend robust supervision and enforcement to ensure these are indeed in place across the industry.[10]

Question 15: Do you agree that proprietary orders can only be price takers? If not, please explain.

No, not if the orders are arm's length internal orders (unsolicited, with the order having no associated economic benefit, cost or risk to the syndicate desk itself). In practice, if arm's length orders constitute the majority of demand, they will affect the price.

Question 16: Do you agree that a CMI's proprietary orders and those of its Group Companies should also include orders placed on behalf of funds and portfolios in which a CMI or its Group Companies have a substantial interest? If not, please explain.

No, not if the orders are arm's length internal orders and are entered transparently into the book.

ICMA would reiterate the importance of institutional information barriers between the private and public sides of a bank, and other safeguards to ensure that such internal orders do not present a conflict of interest and are not informed by any non-public information about the transaction.

We also note that the question of scope is relevant here, and that if the proposed Code is applied inconsistently in a specific transaction, then there could be some syndicate banks allowed to consider internal orders *pari passu,* and other syndicate banks effectively prohibited from doing so.

Question 17: Orders received and entries placed in the order book are subject to constant amendments and updates throughout the bookbuilding process. Do you think it is feasible for the OC and CMIs to maintain records which evidence every change? If not, please explain.

Generally, yes, though the record keeping requirements should be proportionate.

In terms of accepted international DCM practice standards, underwriters keep adequate records of orders received and accepted into the order book. Records are also kept in external platforms that are used for order processing in debt syndication.

[10] We note that the existing SFC Code of Conduct, para. 9.1, provides that client orders should have priority over internal orders for the account of the licensed or registered person or for related accounts. It is unclear how this would currently apply to DCM primary market transactions, but ICMA's recommendation would be as outlined in our response to Question 14 and to effectively exclude legitimate arm's length orders in the context of DCM primary bond offerings.

The consensus view of ICMA members is that it would be disproportionately burdensome to require that OCs and CMIs record individual allocation justifications and related communications throughout the bookbuilding process. Having to record and justify every change to the order book, including details of every situation when the issuer does not follow syndicate recommendation, would not improve the audit trail in a substantive way over current practice.

ICMA would recommend more precise guidance on what constitutes "key" discussions or recommendations for purposes of the record-keeping requirements in Section 21.4.8 of the proposed Code. This section could also be qualified by requiring that OCs "take reasonable steps" to document the relevant items.

The question of scope for DCM transactions is also relevant to this question. For an international transaction, syndicate members may wish to avoid a Hong Kong nexus if the record keeping requirements under the Code are disproportionately burdensome. This could increase the risk of regulatory arbitrage.

Question 18: Do you agree with the scope of fee-related advice to be provided by an OC to an issuer? If not, please explain.

No.

ICMA's view is that OCs would be conflicted from advising issuers on remuneration for syndicate members.

Question 19: Would you envisage substantial practical difficulties in an issuer determining the syndicate membership, the ratio between the fixed and discretionary portions of the fees to be paid to all syndicate CMIs and fixed fees allocation four clear business days before the Listing Committee Hearing? If yes, please cite examples.

This question is specific to ECM.

For DCM, ICMA strongly supports early appointment of all syndicate members, confirmation of their individual roles, and confirmation of their individual share of the "fixed" element of overall syndicate remuneration before the public announcement of the transaction.

Question 20: Would you envisage substantial difficulties in issuers determining the allocation of discretionary fees and the fee payment schedule no later than listing? If yes, please cite examples.

This question is specific to ECM.

For DCM, ICMA suggests fees, both fixed and discretionary, should be paid at settlement (deducted from the gross issue proceeds). This would be in line with international DCM accepted practice.

Question 21: Do you agree that (i) the syndicate membership (including the names of OCs) should be disclosed at an early stage; (ii) the total fees to be paid to all syndicate CMIs participating in the offering for the international placing tranche should be disclosed in the prospectus; and (iii) the total monetary benefits paid to each syndicate CMI should be disclosed after listing? If not, please explain.

This question is specific to ECM, but for DCM:

(i) ICMA agrees that syndicate members should be disclosed on announcement.
(ii) Fee disclosure tends to be relatively rare in international DCM practice (which is generally institutional in nature). ICMA does not recommend fee disclosure for DCM transactions.

Question 22: Do you agree with the “sponsor coupling” proposal? If not, please explain.

This question is specific to ECM and not applicable to DCM.

Question 23: Do you think one Sponsor OC is adequate or should more OCs be required to act as sponsors? For example, should the majority of OCs be required to act as sponsors (ie, if the issuer appoints three OCs, two must also act as sponsor)? Please explain.

This question is specific to ECM and not applicable to DCM.

Question 24: Do you have any comments on the proposed implementation timeline?

A longer implementation timeline may be needed, and an interim review of the Code amendments would be useful.

ICMA would recommend a one-year transition period for the industry to comply after the publication of the revised Code. Intermediaries may need more than six months, particularly if they would need to hire and train additional compliance staff. Syndicates may also require additional IT investment to comply with some of the operational requirements of the proposed Code.

ICMA could also suggest staged implementation of various parts of the Code as a way to mitigate what we believe to be significant risks of inconsistent application and regulatory arbitrage. These proposals are outlined in more detail under our response to Question 2.

Finally, as with any new area of regulation, a review of the new Code provisions after an initial period of operation (perhaps two years) could help address any residual problems with market behaviour. This could enable the initial Code provisions to be calibrated less stringently, leaving the option for more stringent regulation if the SFC considers the initial impact of the proposed Code to have been insufficient. This approach would also reduce the risk that the proposed Code might have a detrimental effect on Hong Kong market efficiency and activity.

Additional matters related to the consultation

SFC supervision

The consistent view of ICMA stakeholders is that effective and efficient regulation under the proposed Code should entail both appropriate rule-making together with regular SFC supervisory inspections of underwriters and investors and any related enforcement measures.

Conflicts of interest arising from competitors

Some ICMA members are concerned with the implication in the Consultation that a conflict of interest may arise where the CMI is also involved in a transaction for a competitor of the issuer (paragraph 64(b), p. 21). ICMA's view is that such a presumption is overbroad in practice and potentially counterproductive. In reality, a large international bank that is active across many markets and many products (for example, corporate lending, hedging, corporate advisory, etc. in addition to DCM) may undertake many transactions at the same time involving companies that compete with one another. As a matter of accepted practice, international banks in DCM syndicates routinely have systems and controls in place (including information barriers) to review and properly manage potential conflicts across the firm in line with their own individual compliance policies.[11] ICMA believes that these are adequate to manage potential conflicts in the DCM primary markets, and would request clarification in the Code that there be no additional compliance measures (or routine involvement of senior management) necessary if a bank happens to be working for a competitor of the issuer in another capacity (which will very often be the case) and the relevant bank's own view is that it is able to properly manage any potential conflicts of interest.

Risk management (hedging) transactions

In general, DCM issuers may wish to hedge their exposure to underlying interest rates and currency movements, and may approach banks including syndicate members to provide the hedge.

Ultimately, it may not be realistic to expect that issuer hedging needs will *never* impact the benchmark referenced for the pricing of a new bond issue (though one may seek to mitigate any potential impact). Consequently, ICMA would recommend that the Code should instead require syndicate members to affirmatively inform issuers that any intended risk management transactions by them could affect the pricing of a new issuance.

Senior management

ICMA would expect senior management of DCM syndicate firms to have established appropriate internal policies and related escalation procedures. Also, many DCM transactions are executed entirely intra-day with no prior marketing period, and any single underwriter may be executing several DCM transactions every day.

Therefore, the consensus view of ICMA constituents is that it would be disproportionate, and inconsistent with accepted international DCM practices under existing regulations internationally, to require their involvement in granular decisions related to bond syndication.

[11] We also note that GP 6 and para. 10 of the SFC Code of Conduct expressly address management of potential conflicts of interest.

Further consultation

ICMA believes that several aspects of the proposed Code, and the legal text itself, would merit further consultation with the SFC before implementation. These include but are not limited to:

- Scope of transactions to which the Code would apply
- Equity-linked bond transactions and relevant obligations of OCs and CMIs
- X-accounts and “omnibus” orders
- Definition and disclosure of “associated” investors in the DCM context
- Options for phased implementation

Annex 1

Prior versions of the ICMA Primary Market Handbook – extracts on the 'pot' system

Set out below is Guidance Note XII relating to the 'pot' system, extracted from the May 2015 version of the Handbook (having been in successive versions since November 2002). This item was deleted from the September 2015 version of the Handbook on the basis that the pot system was by then so established in the international primary bond markets that ongoing inclusion was not justified.

The cited Recommendation 1.20 (also since deleted) has however not been reproduced as being materially out of date.

Guidance Note XII – The pot system *(November 2002)*

XII. THE POT SYSTEM

IPMA published Recommendation 1.20 (Pot Distribution) today. Recommendation 1.20 addresses the disclosure to be made by Bookrunners to syndicate members when launching a debt issue which is to be distributed by the 'pot' method.

The purpose of this explanatory memorandum is to provide some practical information on the pot system and pot system terminology, as currently used in the European international debt primary markets. Market practice in this area is continually evolving, and individual transactions are structured according to their specific circumstances. This memorandum is not intended to prescribe or endorse particular structures or practices. It is a cornerstone of the IPMA Recommendation that all relevant information must be clearly described to syndicate members when they are invited into a new issue.

BACKGROUND

In a 'pot' distribution, all or a portion of a new issue is set aside to be allocated to investors out of a central orderbook run by one or more of the Bookrunners for the issue. Other syndicate members contribute orders to the pot, but do not control the final allocation or distribution of bonds. This well-established US market practice has become common in the Euromarkets, including, but not only, benchmark issues, issues for investment grade and non-investment grade corporate borrowers and financial institutions, issuers who raise money in the capital markets infrequently, and structured issues such as Tier 1 capital. This method of distribution contrasts with the traditional Euromarket practice, whereby managers receive an allotment of bonds at the discretion of the Lead Manager, which they sell directly to their clients. This 'underwritten' distribution method (so-called because the Bookrunners 'underwrite' the price with the issuer based on existing market levels rather than deal-specific investor demand) is commonly used with frequent borrowers for whom market pricing and yield curves can be easily established.

The following comments are a guide to some current practices.

POT STRUCTURES

100% Pot: If a deal is launched as a 100% pot, the Bookrunners allocate the entire issue to investors brought into the pot by the Bookrunners and syndicate members. Co-lead and co-managers are invited to join the underwriting group for the issue, but do not receive an allotment of bonds, and do not determine which investors receive bonds.

Retention bonds: If a pot issue is launched with retention bonds, syndicate members who are not Bookrunners receive an allotment of bonds at a pre-announced specified percentage or amount of their underwriting commitment, which they sell directly to their clients, without disclosing to the Bookrunners which investors have bought them. The remaining bonds are allocated to investors from a pot managed by the Bookrunners.

Incentive pot: In some pot deals, a portion of the issue is set aside to be filled by orders from co-lead and co-managers. They may share one pot, or each group may have a separate pot. This structure may be used, for example, if there is likely to be specialist interest in an issue, because, for example, the issuer is well known in a particular region. The Bookrunners allocate orders contributed to this pot to the nominated investors at the Bookrunners' discretion, and the managers who bring orders in to the pot typically receive fees linked to the orders they submit, if they are filled out of the pot (see Economics below). Incentive pot bonds not subscribed through the incentive pot are allocated at the Bookrunners' discretion, but are often taken up by the Bookrunners. An incentive pot is sometimes called a performance pot or a flexipot.

Strategic reserve: issues for borrowers such as multilateral agencies and government issuers are occasionally launched with a small portion of the issue set aside for co-lead and/or co-manager orders. These bonds are allocated to investors by the issuer from orders brought into the pot by the co-lead and/or co-managers. As with other structures, bonds not taken up through the pot are allocated at the Bookrunners' discretion.

Selling group: Pot deals sometimes also include a selling group. The selling group is selected and managed by the Bookrunners. The Bookrunners allocate bonds to the selling group out of the Bookrunners' pot or retention bonds, based on demand, on a 'take and pay' basis.

ECONOMICS

Fee structures, like pot structures, continue to evolve. The following are examples of some structures currently in use.

Fixed economics: This refers to the fees which a co-lead or co-manager receives on a new issue pot deal, which are not linked to investor orders that that manager contributes to the pot.

Full fees: This is the most common fee structure for 100% pot deals. Managers receive combined management, underwriting and selling commission (i.e. 'full fees') based on their underwriting commitment, although they do not receive any bonds.

Incentive pots and strategic reserves: Co-leads and co-managers typically receive 'full fees' on their underwriting commitment (which includes any allotment of retention bonds). In addition they may receive either 'full fees' or selling concession on the sole orders they bring in to the pot which are filled. Managers do not typically receive fees on orders they place which are not filled. Fees on filled investor orders placed by more than one co-lead or co-manager are allocated at the Bookrunners' discretion.

Retention bonds: Co-leads and co-managers receive management, underwriting and selling commission on the part of their underwriting commitment which is designated 'retention'. Additional fees vary according to the structure of the pot – for example, 'full fees' on the balance of their underwriting commitment, or management and underwriting commission on the balance of their underwriting commitment and selling concession on orders in the pot which are attributed to co-lead and/or co-managers.

Selling groups: Selling group members do not underwrite the issue, and do not receive a management or underwriting fee. They are paid selling concession on their allotment.

Investors: Investors buy pot bonds at the re-offer price. In most issues the re-offer price and the issue price of the bonds are the same.

INVESTOR TRANSPARENCY

Pot issues generally require syndicate members who are putting orders in to the pot to disclose the names of their investors, either to the Bookrunner, or, if the issuer is managing a strategic reserve, to the issuer. The IPMA Recommendation states that any requirements to disclose investor names must be described clearly before invited managers have accepted their invitation to join the syndicate. Occasionally small orders are accepted from managers who have an investor who does not want his or her name disclosed for confidentiality or bank secrecy reasons (so-called Account X orders).

INVESTOR ORDERS AND ALLOCATION

Investors may place orders with each Bookrunner and/or syndicate member with whom they have a relationship. This is a recognised market practice.

There are no consistently applied conventions for placing and filling multiple orders, and an order of 6 million left with each of three Bookrunners may be interpreted as total investor interest of 18 million, or total investor interest of 6 million. Investors need to state clearly their total level of interest when leaving multiple orders, and Bookrunners need to be sure they understand the basis on which multiple orders have been placed before allocating bonds.

SETTLEMENT

Bonds are allocated to investors and, where relevant, managers, within a short time of deal pricing, usually 24 hours. Managers who bring orders in to an incentive pot typically settle the allocation they receive from the incentive pot directly with their investors. The Bookrunner responsible for settling the issue (Settlement Manager or Billing and Delivery Manager) is expected to pay fees to syndicate and selling group members on the payment (closing) date of the issue. If there are retention bonds, managers with retention bonds may be instructed to deduct their fees from the payment they make to the Settlement Manager. Instructions for payment are included in the Invitation or Allotment notice. If an issue consists of more than one tranche, there may be more than one Settlement Manager.

HEDGING

In a typical pot deal, one of the Bookrunners may arrange the hedging for the pot bonds which are settled through the Settlement Manager.

SECONDARY TRADING

Bookrunners will usually provide liquidity in the new issue, in normal market conditions. Bookrunners do not run a joint secondary book, and there is generally no investor name give–up in the secondary market.