International
Capital
Market
Association

ICMA

ICMA response to ESMA Level 2 Consultation Paper on MiFID II / MiFIR

Below is the consolidated response ICMA submitted on 1 August 2014 to ESMA's 22 May 2014 Consultation Paper on MiFID II / MiFIR (ESMA/2014/549) on the ESMA-mandated form, as supplemented by an annex ICMA submitted on 21 August 2014.

ICMA responded to questions Q58 to Q62 of the Consultation Paper from the perspective of its primary markets lead-manager constituency – see further the initial paragraphs of the response to Q58 on page 2 for detail.

ICMA responded to Q24 and certain questions between Q121 and Q151 from the perspective of its secondary markets constituency – see further the initial paragraph of the response to Q24 and Q121 on page 11 for detail.

The Joint Associations Committee on retail structured products, which ICMA supports, also submitted a response to the Consultation Paper from that specific perspective, which is being separately published on the ICMA website.

ICMA also responded to ESMA's 22 May 2014 Discussion Paper on MiFID II / MiFIR (ESMA/2014/548), which is being separately published on the ICMA website.

ICMA PRIMARY MARKET RESPONSES

Underwriting and placing – conflicts of interest and provision of information to clients

Q58. Are there additional details or requirements you believe should be included?

1. **Scope of response** – The International Capital Market Association ("**ICMA**") is responding to Questions Q58 to Q62 in section 2.10 (on underwriting and placing) of this ESMA/2014/549 consultation paper ("**CP**") in relation to its primary market constituency that lead-manages syndicated debt securities issues throughout Europe. This constituency deliberates principally through ICMA's Primary Market Practices Committee[1], which gathers the heads and senior members of the syndicate desks of 46 ICMA member banks, and ICMA's Legal and Documentation Committee[2], which gathers the heads and senior members of the legal transaction management teams of 19 ICMA member banks, in each case active in lead-managing syndicated debt securities issues in Europe. These responses are made in the context of the international syndicated wholesale/institutional issuance of investment grade 'vanilla' (typically fixed/floating rate USD, GBP and EUR-denominated) corporate bonds / debt securities (Eurobonds). ICMA is distinctly responding from the secondary markets perspective and from the retail structured product perspective (via the Joint Associations Committee) to other questions in the CP and also to ESMA's Discussion Paper on MiFID II / MiFIR (ESMA/2014/548). ICMA expects others (such as general banking associations) will also be responding in relation to cross-cutting aspects that do not impact debt securities issues exclusively.

2. **Form/structure of response** – It is crucial for the success of Europe's single market that ESMA obtains a proper understanding of the issues arising around its proposals. In particular, it seems ESMA is not actually seeking feedback on the specific draft technical advice it has proposed, in CP pages 84-87, to submit to the European Commission. Indeed the specific CP questions Q58 to Q62 relate only to additional points, the specific aspect of hedging and practical implementation aspects. It seems fundamental that European policies be developed on a sound, considered basis, and so a proper review of the draft advice and any underpinning rationale needs to be expressed in these responses. The ESMA prescribed response form may however not facilitate public reading of these responses, and so ICMA will publish a reformatted version on its website for public use. These responses have been drafted to the best of ICMA's ability and so ESMA should advise ICMA if the meaning any part of these responses seems unclear to it – ESMA will otherwise be developing a regulatory architecture without an understanding of all the arising issues. ICMA looks forward to ESMA's feedback statement in terms of the rationale behind ESMA's final position (and of course particularly where it diverges from the points set out in these responses). ICMA hopes that the Commission will subsequently consult on the text of the delegated act to ensure it takes proper account of the ESMA advice and all the feedback received.

3. **Distinction between shares and bonds** – Much of the background commentary in CP section 2.10 (in pp.75-84) seems to have been drafted without clear distinction between shares / equity securities and bonds / debt securities although there are big differences between these two types of securities, in terms of why and how they are issued, bought and sold. This response seeks to identify where aspects of the CP's background commentary do not seem to make logical sense, at least in the context of bond markets. To the extent ESMA is seeking feedback in relation to the equity/IPO markets, ICMA understands AFME (the Association for Financial Markets in Europe) is submitting a response to the CP.

4. **Eurobond execution process** – It therefore seems worthwhile to briefly explain the most pertinent aspects (for the CP questions) of how a 'book-built' syndicated corporate Eurobond issue is ***typically*** executed today (bearing in mind issuance methods evolve continuously), which is done in #5-#13 below. There may be much variance in actual practice in individual cases, in response to specific needs and circumstances.

[1] See http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Primary-Market-Practices-Sub-committee/.
[2] See http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Legal-and-Documentation-Sub-committee/.

5. A lead-manager's origination desks constantly seek to inform existing and potential issuer clients with market 'colour': the lead-manager's assessment (based on investor dialogue and recent primary market activity) as to how the new issuance markets are performing generally and its expectations of what kind of issuance terms (size/maturity/yield combinations) the specific issuer might be able to obtain should it choose to launch a transaction. If an issuer is seriously considering a transaction, it requests proposals from individual lead-managers, which notably include information on (i) issuance pricing and terms expectations, (ii) related investor base dynamics/options, (iii) lead-manager expertise and (iv) fee/cost arrangements/estimates.

6. Following subsequent discussions, the issuer then **mandates** those lead-managers it wishes to retain as a syndicate to actively run the transaction, fixes the fees and instructs them as to which junior co-managers to invite into the syndicate. The lead-managers' syndicate desks then proceed with the transaction, referring back *throughout* to the issuer whenever necessary (the degree dependent on their detailed understanding of the issuer that in turn depends on the granularity of their prior discussions on this or in any previous transactions[3]), and otherwise involving the issuer to the extent it desires and is willing to make the relevant staff available – *decisions are ultimately the issuer's*.

7. Based on their general market knowledge and any available specific information, the mandated lead-managers **announce** the transaction (issuer name, maturity and any size indication) and then open the order book on publication of initial price guidance. This guidance is a spread range over an appropriate reference rate, e.g. +15-25bp or +20bp 'area' (basis points or hundredths of a percent) over mid-market swap rates of the same maturity. Lead-managers' syndicate desks contact their public-side sales desks who then contact investors to flag the transaction. Interested investors will place conditional orders[4] (e.g. €20 million at +15-20bp and €30 million at +21-25bp) with the sales desks, which pass them on to their syndicate desks for inclusion in the book. Depending on the volume of accumulating orders, the lead-managers' syndicate desks revise price guidance as they seek to secure the best (lowest) yield for the issuer commensurate with sufficient 'solid' distribution/demand (in relation to the issuer's funding maturity/size objectives): 'stakeholder' investors that are 'committed' to the issue and so will (i) not immediately on-sell and so depress the price / increase the yield (causing other investors to regret acquiring their bonds in the primary issue rather than in secondary trading and in turn prejudice the issuer's attractiveness for subsequent returns to the market) and (ii) be likely to stand by the issuer and engage in any reasonable restructuring discussions if this unexpectedly came to pass the in future (rather than immediately on-selling to a 'vulture' fund). See further #21 and #22 in this respect.

8. Once the book has reached the right size and character (with investors hopefully adjusting their conditional orders as price guidance is revised), the lead-managers' syndicate desks close it and formally **launch** the deal by announcing its definitive size and spread (e.g. €1 billion at 17bps). Very frequently in the initially volatile and then low interest rate environment of recent (post-crisis) years, demand has so exceeded supply, that, even at the lowest plausible yield, order-books have been many times oversubscribed. Also the number of investor 'accounts' in order-books has increased from about an average of 50 pre-crisis to up to 500 now. (Lead-managers cannot simply reduce the yield to exactly match demand, as there is an inflection point at which demand suddenly drops significantly from oversubscription to near-zero.)

9. Following launch, lead-managers as a syndicate determine the book size at the final spread (crystallising the conditional orders), scrub duplicate entries. Then, as a syndicate and based on their general allocation policies (that generally focus on 'solid' distribution as noted in #7 above) and any issuer specific priorities (such as diversifying its investor base into a particular geography), they first establish general allocation percentages for each type of investor and then individually review/adjust each order in light of individual considerations (e.g. early, proactive and useful investor feedback on what the transaction size/yield could be, likely holding horizon, available explanation of any order size apparent inconsistency with assets under management or prior investment history, etc.). Once the **allocations** have been approved by the issuer, the lead managers **price** the bond, effectively a formality: the issue price is (if needed) adjusted down from 'par' (100% of nominal/face value) to materialise the definitive spread at a coupon that meets the

[3] So there will be less need for both initial and ongoing discussion with frequent issuers.
[4] Including orders "at reoffer" that are effectively conditional on the current price guidance (and so would need to be reconfirmed or amended following any revision of price guidance).

historic convention of being expressed in 1/8ths of a percent (0.125%, 0.25%, etc). This involves computation of future cashflow net present values until the bond's maturity. Therefore a five year USD bond pricing 'flat' (at a nil spread) to a mid-swap rate of 1.769% would use a coupon of 1.75% and therefore a reoffer price of 99.91% of par.

10. During the new issue execution process, both issuer and investors are subject to the 'market risk' that an intervening event unrelated to the issuer specifically (such as a central bank announcement on interest rate changes or another issuer's insolvency) will significantly impact the attractiveness of issuer funding / investor investment alternatives. Modern technology enables lead-managers to execute new issues swiftly and issuers and investors expect them to do so: the *time lapse between 'announcement' and 'pricing' above is a matter of hours* (at least for established issuers), often 8am to 4-5pm. Lead-managers consequently have to operate a very streamlined process, with very limited room for non-essential actions.

11. After pricing, the lead-managers finish preparation of contractual/other documentation and any stock exchange listing application (they may have had insufficient time prior to announcement if seizing a favourable market 'window'). Documentation is often available on a shelf-basis in the form of debt issuance programmes. **Signing** of the subscription (and underwriting) agreement between issuer and lead-managers occurs three working days[5] after pricing and **closing/settlement** of the issue (when the bonds are actually issued and delivered to investors) follows a further couple of days later, so there is working week between pricing and the actual issuance. The lead-managers contractual underwriting obligations run from signing to closing, though their reputational risk can extend wider than this. See further #24.

12. **Trading** in new bonds can begin at any time – even prior to closing/settlement (the trades are on a conditional "if and when issued" basis). For example, two persons could agree to trade €20 million nominal of a bond (valid contracts usually just require enough certainty around the identity of the potential bond) at a price of 100.315% of nominal. Such 'grey market' trades are settled simultaneously with settlement of the primary issue. Lead-managers however do not participate until the bonds are free to trade following pricing. Between pricing and closing/settlement, lead-managers watch the bonds in case they stray much from their issue price (and so the final spread investors opted into) because of, for example, other transactions, misjudging of 'solid' demand, unrelated supervening events, etc. They do so for the reasons noted in #7/#22. To the extent necessary and possible, they may buy back bonds in the (grey) market on their own account, in order to try to increase the price and so keep the spread constant over the reference rate (see further #25 and #26). Such '**stabilisation**' is regulated under the Market Abuse Directive.

13. In addition to the CESR responses to Commission Question 21 cited in Paragraph 10 of CP section 2.10, more detail can be found in ICMA Explanatory Note XIII in the ICMA Primary Market Handbook[6] (ICMA would be happy to provide complimentary Handbook access to ESMA on request to ruari.ewing@icmagroup.org).

14. **Basic response to Q58** – There are no additional details or requirements that appear necessary to be included. However, several aspects of the draft technical advice do not appear to entirely make sense and need amendment. ➔ *Except as noted below*, the draft technical advice seems workable.

15. **Conflict of interest background** – Requiring lead-managers to have "organisational arrangements and procedures" was noted as an option to be explored further in ICMA's February 2011 response[7] to the European Commission's 2010 MiFID consultation[8] (c.f. paragraph 56 and more generally paragraphs 45-63), in contrast to requiring "specific rules" or "specific conflicts of interest requirements" (as it was unclear from the consultation what this might mean in practice). The Commission's subsequent impact statement[9] retained the first option for further policy development (c.f. sections 3.8, 5/9.4, 6.9/9.4, Annex 3/13.9 and Annex 4/9.4). Distinctly, ICMA's

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[5] At least where the bonds are not also being placed into the United States pursuant to Rule 144A.
[6] See http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/ipma-handbook-home/.
[7] See http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/MiFID-Related-Documents/ICMA%20response%20to%20Commission%20MiFID%20consultation%200%202%20Feb%202011%20(3).pdf.
[8] See http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf.
[9] See http://ec.europa.eu/internal_market/securities/docs/isd/mifid/SEC_2011_1226_en.pdf.

predecessor organisations, IPMA (the International Primary Market Association) and ISMA (the International Securities Market Association) issued in 2004 (in the context of COB 5.10 of the UK then FSA's *Handbook of Rules and Guidance*), together with the British Bankers' Association, *Guidance on Policies and Procedures for Managing Conflicts of Interest in the Context of Allocation and Pricing of Securities Offerings*[10] (the "**2004 Joint Guidance**").

16. **Syndicate formation** – Paragraph 10 of CP section 2.10 states that lead-managers may "have an interest in keeping a key competitor out of the syndicate group for a lucrative offering, at the expense of the issuer client". It is the issuer clients who decide how many and which lead-managers will be part of the syndicate for their issuance transactions (and can subsequently add or remove lead-managers from the syndicate) – rightly so as the transactions are theirs. Syndicates generally need to be of limited size (at least in terms of the active members), since (as with any human activity) having too many managers can slow down and otherwise bring inefficiency to the issuer's transaction – a point *inter alia* flagged recently by a UK investor body to the UK's Financial Conduct Authority, suggesting the number of bookrunners be capped at four. Though syndication is an art and not a science on which hard numbers can be placed, lead-managers try to sensitise issuers clients to the considerations involved. Lead-managers compete strenuously to be included ahead of their peers in the syndicate and presumably no one would suggest that vigorous competition should be discouraged in this respect. In any case, the regulation of competition is covered under specific EU regimes and should be distinct from the general competence of securities markets regulation for which ESMA is empowered under MiFID.

17. **Advising to undertake an offering** – Lead-managers do not, as a matter of course, provide 'corporate finance' advice to issuer clients. As noted in #5, lead-managers (via their origination/DCM functions) inform issuer clients of potential issuance windows in the market, namely in terms of potential bond pricing/size/maturity configurations that might be achieved given current prevailing interest rates and patterns of issuance supply and demand. They also inform issuer clients of potential advantages for bond issuance beyond pure funding requirements, such as promoting future funding flexibility (by establishing/widening a historic investor base and maintaining a public yield curve) or even as a general corporate advertising tool (for example issuing 'green' bonds to highlight the 'green' aspects of the issuer client's business).

18. Lead-managers' origination/DCM functions do not however advise issuer clients to undertake a bond offering. That would be part of 'corporate finance' advice, which could also relate for example to structuring repayment/refinancing profiles and comparing non-bond funding options. Where corporate finance advice is undertaken by lead-managers, it will be through entirely separate desks/teams. Often however, corporate finance advice is provided by independent entities retained by the issuer clients (including recently many of the boutique advisory houses that have been established following the 2008 financial crisis) or even resourced in-house by regular/sophisticated issuers. Issuers tend to come to the public bond markets once they are fairly advanced in the corporate lifecycle, and so have experience of many other forms of financing (such as venture capital, SME loans, private equity and even equity IPOs). Lead-managers are often required by issuers to only inform them of bond execution options and not to alternative financing alternatives. Many regular/sophisticated issuers take direct control of the whole process, including bond execution, with no lead-manager advice being necessarily involved at all. ➔ Paragraph 3.i of the draft technical advice is inconsistent with this in its current form and should be deleted. Similarly, other references in the draft technical advice to "corporate finance advice" and to "advising to undertake an offering" should be appropriately revised.

19. Many of the conflict risks outlined in the background to the draft technical advice are highly theoretical. Whilst this does not mean that lead managers should not be organised to address such risks, some relevant nuances in market dynamics are relevant to risk-weighting any related organisational requirements. Three seem particularly relevant to note in relation to this "Advising to undertake an offering" heading:

    (a) in relation to Paragraph 16.i of CP section 2.10, reduced underwriting risk translates, via competitive tendering, into reduced lead-manager fees;

[10] See http://www.icmagroup.org/assets/documents/Guidance%20Paper%2029%20April%202004.PDF.

(b) in relation to Paragraphs 16.ii of CP section 2.10, many bond issues are planned by issuers as just one part of a larger set of transactions involving an acquisition (for example) to be provisionally financed by a bridge loan to be re-financed by a bond; having the same firms involved across all the transactions can promote coordination efficiencies and so save issuer costs (and see also #31 and #32);

(c) in relation to Paragraph 16.iv of CP section 2.10, issuer clients can and do frequently change the lead-managers that participate in their underwriting syndicates, without any investor or market reaction/comment (though issuers do see an advantage in having relationship firms in the syndicate who already have a good understanding of their needs).

20. Lead-managers need a clear understanding of their issuer client's needs in order to be able to effectively manage their issuance transactions. Except to the extent lead-managers have a good understanding of such needs from prior dealings (as touched on in #6), they seek to discuss material aspects of proposed transactions with their issuer client as soon as practicable.

21. **Pricing** – Pricing, like many other aspects of syndication is an art not a science. Lead-managers advertise, based on their general knowledge and any specific sounding, initial price guidance. Investors then submit conditional orders into the book (for example EUR 5 million at price x and EUR 10 million at price Y). Based on the orders received lead-managers may revise the price guidance, with resulting adjustments by investors to their conditional orders, until the size and quality of the order book meets the issuer client's needs (hopefully in as few iterations as possible) – See also #7. On this basis, *intentional* under- or over-pricing by lead-managers would seem fanciful as the transaction is priced to issuer requirements on the one hand and investor demand on the other hand.

22. If anything, there is a risk is that investors do not properly adjust their orders when price guidance is revised, confusing the lead-managers so that they fix too low a yield on the issue ('over-pricing' from the investor perspective) and it widens in secondary trading when many allocated investors decide, on further reflection, to liquidate their holding (e.g. a 5% €100 bond denomination trades down to €99, widening the yield to 5.05…%). As noted in #7, this widening is unpleasant for buy & hold investors who locked into the issue on the lower original yield, and consequently adverse to the issuer in terms of building a loyal investor following for future primary market access. The same effect may also occur if an issuer pursues too aggressively a low yield whilst trying to maintain the same overall transaction size – this being a case where lead-managers inform their issuer client of the potential risk but ultimately they defer to their issuer client's instructions (the consequences are ultimately the issuer client's to bear). Of course, if a low yield is pursued too aggressively and investors do react by adjusting their orders, then the issue may fail to reach the intended size (in addition to the secondary widening aspect noted above) or have to be cancelled altogether.

23. Conversely, there is a risk that lead-managers and their issuer client are too cautious in trying to avoid the above risk and so price the issue too widely ('under-pricing' from the investor perspective), with the opposite effect that the bond yield then tightens too much in secondary trading (e.g. the above 5% €100 bond denomination trades up to €101, tightening the yield to 4.950…%). That may disappoint the issuer client who feels he did not secure the cheapest possible funding. That said, an issuer client will want a degree of tightening in terms of building a loyal investor following for future market access and in any case may see leaving a bit extra on the table for investors as the lesser risk compared to risking future market access through a widening.

24. Contrary to what is supposed paragraph 21 of CP section 2.10, pricing (whether under- or over-pricing) does not impact lead-managers underwriting risk in the prevailing book-built transaction context, as the lead-managers' underwriting is, for practical purposes (and as touched in #11), limited to post-allocation risk of investor default or other major supervening event short of force majeure (and underwriting fees have tightened accordingly). Distinctly, any (accidental) over- or under-pricing cannot impact "existing owners" (only present in the context of a fungible 'tap' issue) as suggested in paragraph 22.i of CP section 2.10, as bond values are (absent specific insolvency considerations) based on wider market interest rate and credit risk parameters. This also applies in relation to paragraph 22.iii of CP section 2.10. Also, overpricing will not increase the amount raised as suggested in paragraph 22.ii of CP section 2.10 – if anything it might even have the

opposite effect if investor demand is reduced as noted in #22 above. It is unclear whether ESMA may specifically have had share issues in mind in these cases.

25. There also seems to be some confusion, in paragraph 21 of CP section 2.10 around the concept of stabilisation – at least in the bond issuance context (the "greenshoe" concept that is cited is generally specific to share issuance). Stabilisation does not help lead-managers mitigate their "own market risk from underwriting". Such risk is limited in any case as noted in #24 above, but more significantly stabilisation is undertaken (after the bonds are free to trade following pricing) at lead-manager expense to support, in secondary trading, the initial yield of the bond (as touched in #12). For example, if the 5% €100 bond denomination trades down to €99 (widening the yield to 5.05…%), the lead-managers may buy back bonds at €100 (securing the yield back to 5%). They would do this to avoid the risks noted in #22 above. The lead-managers undertake stabilisation only rarely (at least in the currently bullish market conditions), because of (i) the potential losses they might incur on any subsequent resale, (ii) the capital charge for holding the repurchased securities on their books and (iii) the detailed regulatory burden of compliance with the Market Abuse Directive's related safe harbour processes.

26. In order to mitigate the first two aspects above , lead-managers may indeed "short-sell" bonds on issue – that is they will over-allot, say, 105 bonds where the issuer will actually issue only 100 bonds. They will do this at the issue price, so there is no "adverse impact on the value" of the bonds (with "adverse" presumably referring to reduction in the capital value of the bond – i.e. an increase in yield). The lead-managers will repurchase the bonds in the "grey" market (i.e. the trades being subject to the bonds being actually issued as noted in #12), with all trades settling at the same time as the new issue itself (stabilisation is generally not conducted after the issue settles). So it may be fair to state that the overallotment/short-selling may mitigate lead-managers' *stabilisation* loss/cost risks rather than their *underwriting* risk – though that hardly seems sufficient to be termed a "hedging strategy". However, lead-managers are under no obligation to stabilise and do so for the issuer's benefit (for the widening-related reasons noted in #22 above), even if the immediate beneficiaries are investors. Consequently, it seems very strange that some underwriting agreements reportedly restrict overallotment as this makes stabilisation less likely (to the issuers' detriment) – such restrictions are not general practice in the Eurobond markets at least. ➔ Paragraph 5.i of the draft technical advice should be reconsidered in this light. Distinctly the first line of Paragraph 5 of the draft technical advice should be clarified to read "[…] should provide issuer clients with information […]" (insertion underlined).

27. **Placing** – Several of the practices stated in CP section 2.10 to be considered abusive (laddering, spinning, quid pro quo arrangements) were previously stated as unacceptable by the 2004 Joint Guidance mentioned in #15.

28. Whilst lead-managers engage issuers on their allocation policies (and requiring policies to be provided to the issuer client before the lead manager agrees to undertake a placing is not logistically impossible), such a requirement is an unnecessary additional burden since an issuer's decision to mandate a lead-manager to undertake a placing will not depend on the lead-manager's allocation policy: most lead-managers' allocation policies are quite similar, are reviewed and effectively agreed across a syndicate's active bookrunners and in any case can be adjusted (within reason and the law) at issuer request after the mandate has been entered into. Furthermore, whilst lead-managers may seek their issuer client's agreement to the lead-manager's existing (not "proposed") allocation policy, their issuer clients may well only request a departure from some aspects of the policy (or may even make no such request). Some issuer clients may refuse to agree to the policy on principle, seeing this as the lead-manager's sole responsibility for which they were hired by the issuer (c.f. the information asymmetry point noted in paragraph 16.v of CP section 2.10). ➔ Paragraph 9 of the draft technical advice should be reconsidered in the light of these points.

29. Regarding paragraph 16.iv of the CP's section 2.10, allocations may indeed be made to firms that are known to be active traders, legitimately, in order to promote secondary liquidity in the issue.

30. **Retail advice / Distribution** – There is no comment regarding paragraphs 31-35 of CP section 2.10 and paragraphs 11-12 of the draft technical advice, as ICMA is responding from the wholesale/institutional markets perspective only.

31. **Lending / Provision of credit** – Paragraph 14 of the draft technical advice ignores the point made in #19(b) above. Impression should not be given that issuer clients seeking staged financing for their projects should be forced to separately structure each limb of the project with different banks (and then hope that the separately structured limbs fit efficiently together). ➔ Paragraph 14 of the draft technical advice should be reconsidered in light of this.

32. Regarding paragraph 36 of CP section 2.10, the appropriate level of lead-manager duties in relation to issuer disclosure has been the subject of decades' worth of statute and case-law. Issuers are the ones responsible for making proper disclosure in relation to their bond issues (notably under the Prospectus Directive). Lead-managers however may well find themselves being pursued whenever an issuer becomes insolvent (as the last person standing with the deepest pockets) and are acutely conscious of the dynamics surrounding due diligence defences in such cases. Banks do share information internally as suggested, though subject to any applicable confidentiality restrictions. Paragraph 36.iii of CP section 2.10 again ignores the point made in #19(b) above. The concerns listed in Paragraph 37 of CP section 2.10, around maximising issuance size without regard for the issuer's financial situation, must be considered in light of:

    (a) the point, in #18 above, that reviewing the amount the issuer should be seeking to raise is a matter of general corporate finance advice that is distinct from the work done by lead-managers in the context of executing bond issuances; and

    (b) investors seeing the mismatch in the issuer's disclosure (assuming no issuer fraud), viewing the excessive borrowing as increasing their credit risk, seeking information as to how the issuer intends to manage its capital structure on a forward-looking basis in this light and then either requiring to be compensated for their extra risk with a substantially increased interest spread or even refusing to buy the issue.

33. **Record keeping** – Keeping a record of the "timing of instructions" is feasible, to the extent it relates to receipt of the issuer's signed mandate letter. Requiring that "the final allocation made for each client should be clearly justified and recorded" may be workable – if this is for each issuer client (➔ in which case paragraph 17 of the draft technical advice should be amended accordingly). It will not be workable if it is for each investor. This is, because with up to 500-odd investors placing orders in most Eurobonds today (compared with 50-odd investors before the 2008 financial crisis), lead-managers have to run the allocation process as swiftly and as efficiently as possible (as both issuers and investors remain exposed until the process is finished to market risk such as a movement in prevailing interest rates) – See also #8 and #10. In order to do this, lead-managers establish general allocation decisions per investor type (based on their allocation policies and any specific requirements expressed by the issuer), which are then adjusted as individual orders are reviewed based on any investor-specific information warranting an adjustment from the general position (see also #9). A potential practical record-keeping option might be for lead-managers to document any allocation that does not manifestly comply with any of (i) the applicable allocation policy, (ii) specific issuer requirements or (iii) the terms of any particular order. Allocation calls are in any case recorded. Ultimately, lead-managers' records should simply be sufficient to enable syndicate staff to explain individual allocation decisions if and when queried by regulators. The requirement in paragraph 17 of the draft technical advice for a "complete audit trail of all steps in the underwriting and placing process" is so wide that is would seem to literally require a continuous audio, video and documentary recording of every action by every lead-manager staff member from the beginning to the end of their employment (particularly given the points in #34 below) – something not required of any other MiFID service and superfluous given the record-keeping requirements in that paragraph. ➔ That wording in paragraph 17 of the draft technical advice should therefore be replaced by "An audit trail of the material steps".

34. **Oversight** – Keeping a record of all "potential" underwriting and placing operations seems highly impractical as lead-managers are in constant communication with dozens of issuers concerning a permanently evolving rainbow of potential bond issuance options. In this respect, identifying a date on which the lead-manager is "informed of [i.e. individual] potential underwriting and placing operations" is frequently impossible (bearing in mind that the many operations never move beyond the "potential" stage). It is unclear what value there is in trying to build procedures around

the "potential" provision of MiFID services, in addition to around the more intuitive "actual" provision of MiFID services (Paragraph 39 of CP section 2.10 is silent on this). Some might think that lead-managers might inform issuers of conflicting issuances coming to market at the same time. Whilst there might be some value in a 'traffic light' system to manage supply, this was a role historically played by some regulatory authorities or central banks that has generally been abandoned as an unnecessary fetter on issuers' flexibility to access the markets (huge volumes of issuance are handled by the markets with relative ease). Lead-managers may at most inform issuers that they expect a particular time frame to be crowded, but are bound by existing contractual and regulatory confidentiality obligations including, to the extent the information may be non-public and price-sensitive, under the Market Abuse Directive. Paragraph 18 of the draft technical advice should be reconsidered this light and even perhaps deleted.

35. **Italy / Article 129 TUB** – It seems propitious in this response to illustrate how national rules can, even in the rather esoteric context of bond allocations, undermine the operation of the common market. The Bank of Italy ("**BoI**") is proposing a re-introduction of post-deal reporting requirements under Art.129 of its TUB (Testo Unico Bancario) regime, which had been suspended for a few years after having been criticised by issuers and market participants. The proposed re-introduction *inter alia* would involve, for each transaction, multiple reporting (punctual, including next day, and periodic) of information, often involving subjective assessments and/or specific computations (rather than merely objective extraction of existing information) – all for non-urgent statistical purposes (and through the use of an on-line platform by BoI). Allen & Overy, with ICMA support, submitted a response[11] in December 2013 to the BoI's original consultation (English translation[12] also public) and is continuing to engage BoI that has so far shown limited interest in revising its proposal. In this last respect, Allen & Overy, with ICMA support, filed a follow-up submission[13] on 14 July (English translation[14] also public). Unless significantly changed within the last round of the consultation process, the proposal may well result in Italian investors being effectively excluded from some international bond offers as allocating bonds to non-Italian investors would not be subject to such reporting requirements.

Q59. Do you consider that investment firms should be required to discuss with the issuer client any hedging strategies they plan to undertake with respect to the offering, including how these strategies may impact the issuer client's interest? If not, please provide your views on possible alternative arrangements. In addition to stabilisation, what other trading strategies might the firm take in connection with the offering that would impact the issuer?

1. In terms of the limited scope of ICMA's response to this question, see #1 of ICMA's response to Question Q58 of this ESMA/2014/549 consultation paper.

2. Lead-managers will seek to ensure their issuer client understands stabilisation, if only to explain that the issuer client may not be able to assume that stabilisation will be deployed if the bonds widen in secondary trading. As noted in #26 of the ICMA response to Q58, stabilisation does not really seem to amount to a 'hedging strategy" and so it is not entirely clear whether there are any *similar* "hedging" or "trading" strategies" a lead-manager might undertake. See further #25-26 of the response to Q58. However, lead-managers do offer their issuer clients recognised hedging strategies in the form of swap transactions entered into in parallel to bond issues (these are offered across the market at competing rates however and issuer clients may well source their hedging needs away from the lead-managers). Such a hedge might for example be a USD/EUR currency swap when a European issuer client (with EUR corporate cash flows) wishes to issue bonds to US investors (who will invest USD and expect USD interest payments), perhaps do diversify its investor base or take advantage of locally favourable issuance terms. However such hedges are entered into by the issuer clients directly and so intrinsically necessitate their involvement. They are however not "hedging strategies" that the lead-managers undertake themselves and so may be outside the scope of this question. Often they may even be part of an issuer client's interest rate strategy (to e.g. secure funding at cheaper USD interest rates than the issuer client's domestic currency).

[11] See http://www.icmagroup.org/assets/documents/Regulatory/Other-projects/Position-Paper-A&O--ITA.PDF.
[12] See http://www.icmagroup.org/assets/documents/Regulatory/Other-projects/Position_Paper-A&O_ENG.PDF.
[13] See http://www.icmagroup.org/assets/documents/Regulatory/Other-projects/Italy-129-Supplementary-20140714-Italian.pdf.
[14] See http://www.icmagroup.org/assets/documents/Regulatory/Other-projects/Italy-129-Supplementary-20140714-English-Tr.pdf.

Q60. Have you already put in place organisational arrangements that comply with these requirements?

1. In terms of the limited scope of ICMA's response to this question, see #1 of ICMA's response to Question Q58 of this ESMA/2014/549 consultation paper.

2. To the extent ESMA's proposed requirements merely bring detail to MiFID2's Level 1 provisions (which have not substantively changed from current MiFID provisions), then lead-managers have been historically required to have in place the policies and procedures necessary to comply with the general organisational requirements around potential conflicts of interest applicable to all MiFID-regulated activities. However to the extent ESMA's proposed requirements do *not* relate to current MiFID's objectives, then lead-managers may well not have related organisational requirements in place. Lead-managers have policies in place as to who they can or should allocate bonds to, and internal staff responsibilities in this respect.

Q61. How would you need to change your processes to meet the requirements?

1. In terms of the limited scope of ICMA's response to this question, see #1 of ICMA's response to Question Q58 of this ESMA/2014/549 consultation paper.

2. There does not seem to be much to say here that cannot be inferred from the ICMA responses to Q58. Where ESMA's proposals are stated to be impracticable, then no process change can be easily envisaged, short of ceasing the business concerned (for example telling issuers they can no longer structure the bridge loan and bond refinancing parts of a transaction with the same bank as noted in #31 of ICMA's response to Question Q58). To the extent ESMA's proposals are not stated to be impracticable, lead-managers either have or will have the necessary processes in place.

Q62. What costs would you incur in order to meet these requirements?

1. In terms of the limited scope of ICMA's response to this question, see #1 of ICMA's response to Question Q58 of this ESMA/2014/549 consultation paper.

2. No cost estimates have been provided by ICMA members, because it is too early to be able to fully understand the implications of ESMA's proposals and so to cost them and as noted above some proposals seem impractical (at least to the extent they would close certain funding channels for European real-economy businesses).

ICMA SECONDARY MARKET RESPONSES

Q24. Do you think that the examples in this chapter constitute an inappropriate use of TTCA? If not, why not? Are there any other examples of inappropriate use of or features of inappropriate use of TTCA?

The International Capital Market Association (ICMA) is a unique organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. Please see www.icmagroup.org. Our response to this question 24 and to questions 121 and following has been prepared on behalf of secondary market participants; we have not sought to provide views from investors and asset managers, who are separately represented in this debate.

Please also see our response to Question 58 for the governance of our response to questions 58 and following.

ICMA has considered this question only from the point of view of the wholesale market. We therefore support the view also expressed by AFME that "The proposals are not appropriate to a number of products where the standard market documents have been developed over a number of years and are constructed with TTCA." One such example is the Global Market Repurchase Agreement developed as the standard agreement for the wholesale European repo market and based upon TTCA. ICMA highlights that this best market practice has been established to create a robust legal framework to underpin repo market activities and that this is for the benefit of both parties to repo transactions. In a repo the economics of the transaction are such that the first party is lending cash, secured against the securities delivered by the second party; and simultaneously the second party is lending securities, secured against the cash delivered by the first party. Hence, both parties have secured exposure under TTCA and each simultaneously enjoys the benefit of this robust legal arrangement.

Delineation between bonds, structured finance products and money market instruments

Q121. Do you agree with ESMA's assessment concerning financial instruments outside the scope of the MiFIR non-equity transparency obligations?

The International Capital Market Association (ICMA) is a unique organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. Please see www.icmagroup.org. Our response to question 24 and to questions 121 and following has been prepared on behalf of secondary market participants; we have not sought to provide views from investors and asset managers, who are separately represented in this debate.
Please also see our response to Question 58 for the governance of our response to questions 58 and following.

ICMA and AFME agree that MiFID Delegated Acts should adopt a definition that includes instruments with short residual maturities as well as short maturities from issuance. Both should be captured by the definition and, ideally, the issuance/residual maturity period should be set at 2 years rather than 397 days.
We also agree with AFME that asset backed commercial paper (ABCP) should be categorised as money market instruments rather than structured finance products.
The relevant difference between a CP and an ABCP is that the cash flows of an ABCP are derived from an underlying pool of assets; this does not affect methods of trading and should not affect eligibility for the definition.

The definition of systematic internaliser

Q122. For the systematic and frequent criterion, ESMA proposes setting the percentage for the calculation between 0.25% and 0.5%. Within this range, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the threshold should be set at a level outside this range, please specify at what level this should be with justifications.

ICMA's response is set out below. The systematic internaliser requirements are new to fixed income markets. 'Systematic internalisers' (as defined) in instruments where there is a liquid market (as defined) must publish quotes they provide to clients, and make those quotes available, subject to stated criteria and limits, to other clients. They must enter into transactions under the published conditions where the quote is below the 'size specific to the instrument' used for pre-trade transparency waivers (see our answer to question 141 below).

It will be important to apply the systematic internaliser rules to fixed income markets in a way that recognises the limited liquidity in many instruments. As well taking account of the exclusion for illiquid instruments, it will be important to give full weight to the specified ability of systematic internalisers to update and withdraw quotes; to decide objectively which clients are to have trading access to them; to refuse transactions on commercial considerations; to set limits on the number of transactions entered into in relation to a particular quote; and to improve on the quote.

ICMA and AFME agree that the appropriate level is 0.4 per cent, for the reasons given in the AFME response.

Q123. Do you support calibrating the threshold for the systematic and frequent criterion on the liquidity of the financial instrument as measured by the number of daily transactions?

ICMA agrees with the AFME response, set out for ease of reference below.

<u>AFME Response</u>

Yes, frequent as a term is clear, and it is logical that frequency would be measured in this way.

Q128. For the systematic and frequent criterion, do you agree that the thresholds should be set per asset class? Please provide reasons for your answer. If you consider the thresholds should be set at a more granular level (sub-categories) please provide further detail and justification.

ICMA agrees with ESMA that there should be different SI thresholds by asset class, namely, bonds, derivatives and emission allowances. We broadly follow AFME here.

Further, we do not recommend any further levels of granularity for fixed income.

Given that the definition of a systematic internaliser applies at instrument-level, it is essential that the MiFID/R regime does not result in an operationally complex regime, which introduces volatility and financial stability risks. The risk of a highly volatile regime would be that investment firms would be an SI in certain instrument one quarter and not an SI another quarter – resulting in firms having to constantly change their statuses and operational systems.

We believe that an investment firm cannot trade an illiquid instrument on a frequent, systematic and substantial basis because there is simply not enough flow to do so. As such, we stress that is it essential that the thresholds for "systematic and frequent" and "substantial" are consistent with the liquidity threshold.

Q129. With regard to the 'substantial basis' criterion, do you support thresholds based on the turnover (quantity multiplied by price) as opposed to the volume (quantity) of instruments traded. Do you agree with the definition of total trading by the investment firm? If not please provide alternatives and reasons for your answer.

ICMA agrees with the AFME response on Fixed Income (FI), the first part of which we set out below for ease of reference. <u>AFME Response</u>: "No. AFME does not agree that the thresholds should be based on the turnover as opposed to the volume. AFME does agree with the definition of total trading by investment firm.

(i) We believe that volume turnover should be based on notional volume rather than on market value. We believe that this extends to all volume calculations.

Reasons:

- Basing turnover thresholds on market value will introduce unnecessary price volatility as a factor into the threshold calculations and thereby introduce uncertainty. For example, if the price suddenly fell from one trade to the next, the aggregate turnover would be highly distortive. It also introduces arbitrage opportunities for firms to price in the SI threshold.

- Instruments do not trade on a price*volume manner – the size of trades, there thereby volume, is determined on the basis of notional not price.

- Market valuation methodologies are not standardised and are highly proprietary. Using market values would create inconsistencies. These inconsistencies would be more notable in the more illiquid end of the spectrum."

Q130. Do you agree with ESMA's proposal to apply the systematic internaliser thresholds for bonds and structured finance products at an ISIN code level? If not please provide alternatives and reasons for your answer.

Like AFME, ICMA support an ISIN level approach for the determination of whether a firm is a systematic internaliser and for the calculation of the liquidity thresholds.

Q133. Do you consider a quarterly assessment by investment firms in respect of their systematic internaliser activity is adequate? If not, what assessment period would you propose?

ICMA believes that a quarterly assessment of a firm's systematic internaliser activity is too frequent. Firms should be allowed to continue to offer the systematic internaliser service for a reasonable period before withdrawing. Firms whose internalisation activity does not meet the thresholds for it to be considered 'systematic' should be able to obtain a 'protective registration' as a systematic internaliser. The timeframe for this should be aligned to the timetable for regulatory approvals in the relevant member state.

Q134. Within the ranges proposed by ESMA, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the threshold should be set at a level outside this range, please specify at what level this should be with justifications and where possible data to support them.

ICMA believes that for the international securities markets, the thresholds should be absolute levels rather than percentages. The reason for this is to ensure that the regime can be operated in practice. It would be preferable for illiquid bonds to be excluded from the systematic internaliser regime on the grounds that an illiquid bond never trades frequently.

Q135. Do you consider that thresholds should be set as absolute numbers rather than percentages for some specific categories? Please provide reasons for your answer.

ICMA agrees with AFME's response on Fixed Income that the percentage thresholds are essential to ensuring 85-95% of the market share of price forming trade for bonds and SFPs are captured by the SI regime.

Orders considerably exceeding the norm

Q139. Do you agree that each systematic internaliser should determine when the number and/or volume of orders sought by clients considerably exceed the norm? Please give reasons for your answer?

ICMA agrees with the AFME response which is set out for ease of reference below.

AFME Response

Yes, the Systematic Internaliser is best placed to understand its own risk profiles.

Prices falling within a public range close to market conditions

Q140. Do you agree that any price within the bid and offer spread quoted by the systematic internaliser would fall within a public range close to market conditions? Please give reasons for your answer.

ICMA agrees that any price within the range quoted by a systematic internaliser falls within a public range close to market conditions.

Pre-trade transparency for systematic internalisers in non-equity instruments

Q141. Do you agree that the risks a systematic internaliser faces is similar to that of an liquidity provider? If not, how do they differ?

ICMA believes that the risks faced by a systematic internaliser are very similar to those faced by a liquidity provider.

Q142. Do you agree that the sizes established for liquidity providers and systematic internalisers should be identical? If not, how should they differ?

ICMA believes, as does AFME, that the sizes established for liquidity providers and systematic internalisers should be identical. But it is questionable whether there is merit in seeking to specify the instrument level as the appropriate context for testing the “substantial” criterion, as firms’ market share may vary.

Data publication

Access to systematic internalisers’ quotes

Q143. Do you agree with the proposed definition of “regular and continuous” publication of quotes? If not, what would definition you suggest?

ICMA agrees.

Q144. Do you agree with the proposed definition of “normal trading hours”? Should the publication time be extended?

ICMA agrees.

Q145. Do you agree with the proposal regarding the means of publication of quotes?

ICMA broadly agrees; it should be clear that firms can use their own website within the term ‘proprietary arrangements’.

Q146. Do you agree that a systematic internaliser should identify itself when publishing its quotes through a trading venue or a data reporting service?

ICMA agrees that that a systematic internaliser should identify itself when publishing its quotes through a trading venue or a data reporting service.

Q147. Is there any other mean of communication that should be considered by ESMA?

ICMA believes that ESMA need not consider other forms of communication.

Q148. Do you agree with the importance of ensuring that quotes published by investment firms are consistent across all the publication arrangements?

ICMA agrees that that quotes published by investment firms are consistent across all the publication arrangements.

Q149. Do you agree with the compulsory use of data standards, formats and technical arrangements in development of Article 66(5) of MiFID II?

ICMA agrees.

Q150. Do you agree with the imposing the publication on a 'machine-readable' and 'human readable' to investment firms publishing their quotes only through their own website?

ICMA agrees.

Q151. Do you agree with the requirements to consider that the publication is 'easily accessible'?

ICMA agrees.