

Conflicts of interest and associated conduct risks during the debt capital raising process

Consultation Report



OICU-IOSCO

**The Board
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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Foreword

The Board of the International Organization of Securities Commissions (IOSCO) has published this Consultation Report to gather market feedback on conflicts of interests and associated conduct risks identified by IOSCO Committee 3 on Regulation of Market Intermediaries in debt capital raisings and on the proposed IOSCO Guidance to address these. Additionally, the Consultation Report requests feedback on the use of Distributed Ledger Technology (DLT) in bond issuances and potential benefits and risks of using this technology, as well as its impact in managing conflicts of interests.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before 16 February 2020**. To help us process and review your comments more efficiently, please use only one method.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

1. Email

- Send comments to consultation-05-2019@iosco.org
- The subject line of your message must indicate '*Conflicts of interest and associated conduct risks during the debt capital raising process.*'
- If you attach a document, indicate the software used (e.g. WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

2. Facsimile Transmission

Send by facsimile transmission using the following fax number: + 34 (91) 555 93 68.

3. Paper

Send 3 copies of your paper comment letter to:

Alp Eroglu

International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a '*Public Comment on Conflicts of interest and associated conduct risks during the debt capital raising process.*'

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Chapter 1 - Executive Summary

Debt capital markets are important to the global economy. The integrity of these markets and the protection of investors depend largely on high standards of conduct by market intermediaries managing the debt capital raising process for issuer clients, as well as the laws and regulations of jurisdictions. These market intermediaries typically are banks, broker-dealers or other types of corporate finance firms.

In a debt capital raising transaction, an intermediary may perform multiple roles and provide a range of services to its clients while having a proprietary interest in the transaction itself. An intermediary involved in the transaction needs to appropriately manage potential or actual conflicts of interest and associated conduct risks. A failure to do so can impact investor choice and returns and investor protection; jeopardise fair, orderly and transparent markets; and potentially curb capital creation, giving rise to poor outcomes in debt capital raisings.

In August 2017, the IOSCO Board approved a mandate for Committee 3 on Regulation of Market Intermediaries (Committee 3) to examine conflicts of interest and associated conduct risks in the capital raising process. The mandate recognised that, notwithstanding existing IOSCO guidance and member jurisdictions' rules, actual or potential conflicts of interest and poor conduct practices may still exist and must be appropriately managed.

The mandate was divided into two stages. Stage One focused on the equity capital raising process. This mandate was completed with the publication of the *Final Report on Conflicts of interest and associated conduct risks during the equity capital raising process* in September 2018.¹

In November 2018, the IOSCO Board approved a mandate for Stage Two, which focuses on the debt capital raising process involving traditional corporate bonds and is the subject of this Consultation Report.²

Conflicts of interest and associated conduct risks identified in capital raisings for traditional corporate bonds

In December 2018, Committee 3 asked its members to complete a survey in line with the IOSCO Board mandate. The survey responses revealed the existence of actual or potential conflicts of interest and associated conduct risks in some jurisdictions³ and that survey

¹ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD612.pdf>

² For the purposes of this consultation report, a traditional corporate bond is a debt security that is issued to an investor in exchange for the funds invested (the 'principal'). It is on maturity of the instrument that the issuer repays the principal. The investor may also receive regular and accrued interest payments (the 'coupons'), depending on the terms on which the bond is issued. Traditional corporate bonds are typically issued by corporates seeking to raise capital other than by way of a loan. Depending on local law, these bonds may enjoy preferential treatment to equity securities in insolvency. For example, a plain vanilla bond offering coupons (based on fixed or floating interest rates notes), a defined maturity period and repayment of the principal at face value would come within this definition.

³ Some members reported that they have controls in place for conflicts of interest and associated conduct risks within their legal and regulatory regime that mitigate the concerns raised in this Consultation Report. Some jurisdictions reported that they manage conflicts through disclosure, although several other jurisdictions do not accept that disclosure on its own is sufficient. As a result, the Guidance in this report may not be appropriate for, or permitted under, the specific legal and regulatory framework of each member.

respondents attributed these conflicts and risks to the multiple roles performed by a market intermediary. Some members also reported that conflicts may arise between the intermediary and its issuer client and between the intermediary and its investor clients. Such conflicts were most evident in the:⁴

- pricing of debt securities and related risk management transactions;
- quality of information available to investors; and
- allocation of debt securities.

The responses also demonstrated that while practices in debt capital raisings and equity capital raisings may be different, some conflicts of interests and conduct risks are common to both. It is for this reason that the proposed Guidance aligns, where appropriate, with the Guidance provided on equity capital raisings, but also differs on some points.

Chapter 3 provides a detailed description of a debt capital raising involving traditional corporate bonds, including the participants and the various stages of the process. Chapter 4 addresses the risks and harms identified by the IOSCO survey and provides an overview of the legal and regulatory framework in certain jurisdictions. The proposed Guidance is set out in Chapter 5.

Proposed IOSCO Guidance

This Consultation Report proposes Guidance to help IOSCO members address the risk of conflicts of interest and associated conduct risks identified in the survey responses.

The proposed Guidance reflects an expectation of high standards of conduct by market intermediaries in the debt capital raising process. Although the Guidance in the box below is not binding, IOSCO members are encouraged to consider the proposed Guidance carefully in the context of their legal and regulatory framework, given the significant potential risks and harms the Guidance intends to address.

While this IOSCO project focuses on traditional corporate bonds, the Guidance may be helpful as IOSCO members consider capital raisings involving other types of debt instruments.

⁴ 17 out of the 20 responses to the IOSCO survey reported potential or actual conflicts of interest and associated conduct risks in debt capital raisings in their jurisdictions.

Proposed IOSCO Guidance

Measure 1: Regulators should consider requiring firms to manage conflicts of interest that may arise in relation to the pricing of a debt securities offering, keeping the issuer informed of key decisions or actions which can influence the pricing outcome and giving the issuer an opportunity to express its preference regarding the pricing of an issue during the pricing process.

Measure 2: Regulators should consider requiring firms to take reasonable steps to disclose to the issuer how any risk management transactions it intends to carry out for itself, the issuer, or investor clients, will not compromise the issuer's interests in relation to pricing of the new issuance.

Measure 3: Regulators should encourage the timely provision of a range of information to investors in a debt securities offering, where distribution of such information is permitted under local law.

Measure 4: Regulators should consider requiring firms to have appropriate controls to identify, prevent where possible and manage any conflicts of interest that arise in the preparation of research on a debt securities offering.

Measure 5: Regulators should consider requiring firms to maintain an allocation policy that sets out their approach for determining allocations in a debt securities offering and for the firm to regularly assess its compliance with the policy.

Measure 6: Regulators should encourage firms to consider their issuer client's preferences e.g. investor profile and composition, when making allocation decisions or recommendations.

Measure 7: Regulators should consider requiring firms to have appropriate controls to identify, avoid where possible and manage any conflicts of interest that arise in the allocation recommendations of a debt securities offering.

Measure 8: Regulators should consider requiring firms to maintain records of allocation decisions to demonstrate that any conflicts of interest are appropriately managed.

Chapter 2- Background and scope

The debt capital raising process is not uniform across jurisdictions and differs in terms of the legal and regulatory framework.

Notwithstanding these differences, in some jurisdictions there remain actual or potential conflicts of interest and associated conduct risks arising from the role of market intermediaries in debt capital raisings.

Previous IOSCO work in this area

Conflicts of interest, particularly those arising from the role of market intermediaries in sell-side securities, have been an area of interest to IOSCO for some time.

In 2003, IOSCO released the *IOSCO Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest: Final Report, September 2003*.⁵ The Statement sets out principles and measures for regulators to implement domestically, following an earlier report which identified the risk of potential conflicts of interest.

IOSCO published the *Market Intermediary Management of Conflicts that Arise in Securities Offerings – Final Report, November 2007*.⁶ The report set out general guidelines for regulators and market intermediaries when considering how to address conflicts of interest that may occur when firms manage securities offerings.

In August 2017, the IOSCO Board identified the need for a new mandate to consider the potential risks and harms caused by conflicts of interest and associated conduct risks during the capital raising process. The mandate was divided into two stages.

Stage One focused on equity capital markets. The work under that mandate identified the following key risks in the equity capital raising process:

- Conflicts of interest and pressures on connected analysts⁷ during the formation of their views on an issuer in the pre-offering phase of an equity capital raising;
- Timing, sequencing and level of information in the offering phase of an equity initial public offering (IPO) capital raising, and the prominence of conflicted connected research⁸ during investor education and price discovery; and
- Conflicts of interest during the allocation of equity securities.

The following additional risks were identified although they were not found to be common to all jurisdictions:

- Management of underwriting risk by firms managing an equity securities offering

⁵ IOSCO Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest: Final Report, September 2003: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD150.pdf>

⁶ Market Intermediary Management of Conflicts that Arise in Securities Offerings – Final Report, November 2007: <http://www.iosco.org.library/pubdoc/pdf/IOSCOPD235.pdf>

⁷ Analysts that are employed within market intermediaries managing a capital raising to produce research.

⁸ Research produced by connected analysts.

and associated conflicts of interest in the pricing of equity securities; and

- Conflicts of interest associated with personal transactions by staff of these firms.

IOSCO mandate – Stage 2

Stage Two considers conflicts of interest and associated conduct risks during the debt capital raising process for traditional corporate bonds.

The work involves determining which issues and potential harms identified in Stage One are common to debt capital raisings and identifying specific debt capital raising related issues and possible solutions through Guidance, as in Stage One.

This work aligns with IOSCO's overarching core objectives since it is intended to:

- Enhance investor confidence in the integrity of the capital raising process and improve the efficiency of this process as a route for issuers to raise finance;
- Improve cooperation and the exchange of information among C3 members on their respective experiences regarding the capital raising process and to help develop markets and implementation of appropriate regulation.

Chapter 3 – Description of the debt capital raising process

This section provides a general description of the debt capital raising process for traditional corporate bonds. The survey responses revealed variations in market practices and the legal and regulatory frameworks across jurisdictions. While the process described is not uniform, it serves as an example to highlight key stages of the debt capital raising process where conflicts of interest may arise.

Overall, the debt capital raising process shares similarities with the equity capital raising process (particularly for debut⁹ or infrequent issuers of debt securities). This said, the two processes differ in several respects. For example, survey responses suggested that firms do not necessarily produce research specifically on bond issuances as they do for equity transactions.

Some survey responses noted that regulatory requirements may differ depending on whether the corporate bonds are admitted to trading on an exchange or offered to the public or are privately placed with institutional investors.

An example of the bond issuance process

In general, most corporate bond issuances are primarily targeted at institutional investors with limited direct retail participation.¹⁰

Most jurisdictions reported that corporate bond offerings are intermediated by a bank or other corporate finance firm. Several responses described the role intermediaries play in managing the corporate bond offering, including gauging early interest in the issuance from potential investors, preparation of documentation, marketing and roadshows, and pricing and allocation of securities.

Survey responses described the bond issuance process as comprising two broad phases, a “pre-offer” and an “offering” phase, although this varied in detail across jurisdictions.

In some jurisdictions, the bond issuance process varies depending on whether the issuer is using capital markets for the first time (a debut issuer) or infrequently, or whether it uses them frequently.

The process described below relates to a debut or infrequent issuer of traditional corporate bonds to institutional investors.

Pre-offering phase

Responses suggested that the pre-offer phase broadly involves matters related to structuring the bond issue, obtaining board or shareholder approvals (as necessary) and appointing firms to manage the securities offering. Some of the key participants in the debt capital raising process typically include banks and other corporate finance firms, as well as lawyers, auditors, accountants, fiscal agents and rating firms.

⁹ Where an issuer is seeking to raise capital for the first time through a fixed income issuance.

¹⁰ Some survey responses clarified that retail bond offerings were uncommon inasmuch as public offerings, which are available also to retail investors, typically have more regulatory and disclosure requirements than private placement offerings, which generally are limited to institutional investors.

Once an issuer decides to raise finance through a bond issuance, it typically runs a formal process by which intermediary firms make a pitch for the mandate to manage the bond offering. Once appointed, the firm (usually part of a syndicate or consortium of banks) may then carry out “pre-soundings” or market soundings¹¹ to seek initial feedback from a small number of investors and representative of the issuers’ targeted investor base.

The timing and the availability of relevant information on the bond offering (e.g. the prospectus, shelf registration document or other documentation relating to the bond issue) varies by jurisdiction and often (but not always) depends on whether the company is a frequent or infrequent issuer of corporate bonds.

Offering phase

The offering phase begins with the issuer making a public announcement of its intended transaction. This would typically set out the issuer’s name, maturity of the bond and any indication of offer size. Information relevant to the corporate bond offering - e.g. a prospectus - may be made available alongside the announcement, though this would not necessarily be a final version (approved by the competent authority), nor would it be publicly available. Instead, it would be in draft form and circulated to institutional investors which have expressed an interest in the transaction. In situations or jurisdictions where a prospectus is not made available at this stage, other transaction documentation (e.g. term sheets) are typically circulated to potential investors.

Pricing guidance is made available to investors and is intended to indicate what the bond issuance price could be. It is common for a bond issuance to be priced off a reference rate¹², to which a spread is then added to reflect the issuer’s credit risk and wider market conditions.

Several responses described a period of active marketing known as the management roadshow, typically lasting two weeks and during which a bookbuild takes place.

Once the book has reached the appropriate size and character and the issuer has approved the allocations, the issuer and syndicate banks hold a pricing call to finalise the price of the offer. The issuer may publish a prospectus approved by the regulator, if required under the law of the jurisdiction. Subsequently, bonds are allocated to investors. A detailed description of the allocations process is found below.

In most jurisdictions, syndicate banks rarely produce research specifically on the bond issuance (connected research). However, issuers, whether debut or frequent, may already have equity shares or other bonds admitted to trading. Therefore, the research divisions of syndicate banks are likely to have general research on the issuer available (e.g. secondary market research or generic credit risk research). Such existing research may support investor decision-making and price formation in the new issuance.

¹¹ Prior to the formal offering of securities, issuers and/or intermediaries may, depending on what is permitted in the member jurisdiction, seek market soundings or initial soundings of prospective investors, award mandates, reach out to cornerstone investors, provide 'early-look' or 'pilot-fishing', meet with analysts to give them information about the firm to enable them to produce research. To note, in certain jurisdictions this practice of “pre-sounding” is rare (e.g. Canada).

¹² Examples of reference rates used for the pricing of new corporate bond issues include mid-swap rates and government bonds.

Frequent issuers

In several jurisdictions, the bond issuance process varies significantly if the issuer is a frequent issuer, which facilitates a quicker and more streamlined issuance. In such cases, bond issuances are typically conducted as part of a standardised debt issuance programme¹³ or rely on existing documentation (such as a shelf registration document) already filed with the regulator.

In several jurisdictions, frequent issuers tend to work with the same firms for further bond issuances, as this provides for a more flexible and faster process than that for debut/infrequent issuers. However, in other jurisdictions, the awarding of the mandate to the lead bank remains competitive, even for frequent issuers.

Based on survey responses, the placing and pricing of the securities can take place within a day. Management roadshows are not necessarily a typical feature for frequent issuers (e.g. Nigeria). Also, some respondents mentioned that “market soundings” are a less common feature for frequent issuers in some jurisdictions (e.g. France).

Once the frequent issuer decides to issue new bonds, it makes an announcement to the market and embarks on a bookbuild (there is rarely a management roadshow). As with a debut or infrequent issuer, pricing guidance is released at the beginning of this period.

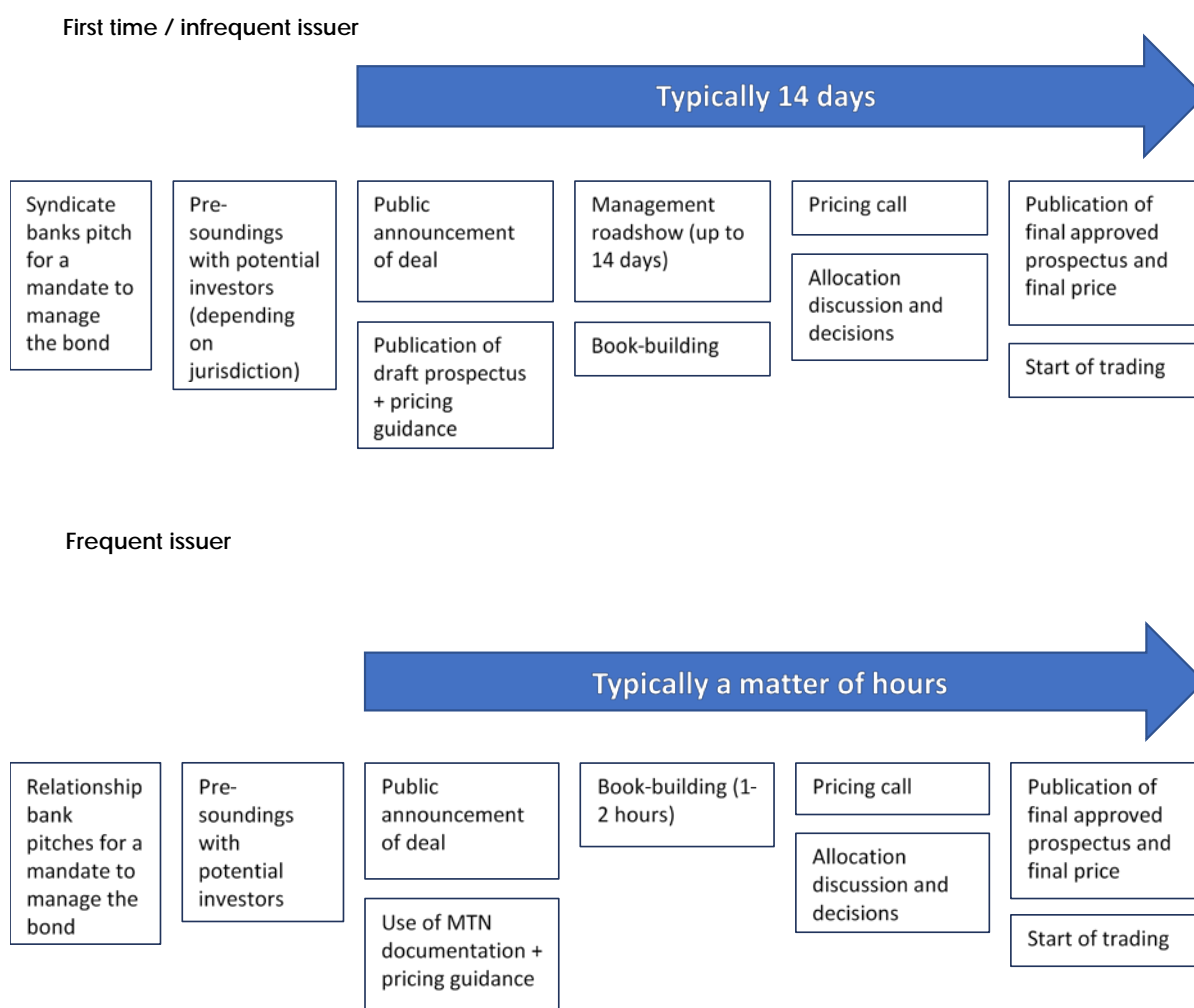
The bookbuild exercise is often carried out at an accelerated basis and can typically be complete within a few hours. Books are rarely left open overnight due to execution risk and movements in the market which could influence the spread and, therefore, the pricing outcome.

Given the pace at which these transactions are conducted, they often involve a smaller number of institutional investors.

Some jurisdictions (Turkey, India, Pakistan, Japan) mentioned that there is no significant difference in process and its stages between infrequent / debut issuers and frequent issuers in their respective jurisdictions.

¹³ Examples include Medium Term Note (MTN) or European medium-term note (EMTN) programmes using a base prospectus approved by the regulator.

Figure 1: Diagrams showing bond issuance process



Pricing and risk management transactions

The firm managing the securities offering is generally responsible for the pricing of the bond issue and, in many cases, the final price is agreed between the firm and the issuer.

Responses indicated that firms consider a variety of factors when pricing a new bond issue. Various responses explained that bonds are typically valued on a relative basis, that is, they are referenced against existing or similar debt securities that are available on primary and secondary markets. In this regard, pricing is generally based on the issuer's (or similar issuers') yield curve or a reference rate to which a spread is added. The book-building process is also a contributing factor in determining the price of the bond (for example, strong demand may result in a lower yield for investors). Also, any market soundings undertaken by the intermediary firm with potential investors helps inform pricing. Publicly available ratings published by Credit Rating Agencies (CRAs) are also cited as a key factor affecting bond pricing, in addition to prevailing market conditions.

Several survey responses suggested that it is common for issuers, investors and intermediaries (e.g. the syndicate banks) to engage in risk management transactions to mitigate the risk of movements in the reference rate between the initial pricing guidance and price finalisation or

to move between different interest bases.

The allocations process

The survey responses revealed a significant difference in the allocations process for private placements and public or listed offerings. Private placements in many member jurisdictions are typically limited to institutional or professional investors. Survey responses also showed that while allocations in public or listed offerings are governed by the jurisdiction's regulatory framework, private placements are generally negotiated on private and commercial terms. Private placement transactions and their participants may be subject to different and less stringent regulatory obligations and disclosure requirements.

The survey findings also revealed that a market intermediary takes into account a range of factors in its allocation recommendations and decisions.

Members reported that the information gathered through the book building process may form the basis of discussions between the firm and its issuer client on allocations, taking into account a number of key considerations, including:

- The issuer's preference regarding the investor composition;
- The size of the order made by an investor;
- The length of the investor-client relationship, including previous participations in similar debt capital raisings, and the prospect of future, client-relationship based business;
- The investor's long-term commitment to the issuer;
- Investor profile and portfolio structure;
- Proportion of subscriptions, subscription rate offers and oversubscriptions; and
- The timing and receipt of bids.

In terms of final allocations determination, responses varied on the extent of the issuer's involvement and whether it is the issuer or the firm that makes the determination.

However, there are also other processes for determining allocations, such as:

- Allocations in many private placements are done on a yield basis. When two or more bids are at the same yield, allocations are done on a 'time-priority' basis. A 'pro-rata' basis for allocations will be done for two or more bids with the same yield and time. Bids are loaded onto the electronic booking platform with bidders listed anonymously and in ascending order of yields and allotment; and
- In the event of oversubscription, allocations may be done on a 'time-priority' basis, reduced pro-rata and/or reduced on a case-by-case basis. A case-by-case reduction involves the selective reduction of orders at the discretion of the firm or lead syndicate/lead manager.

Quality of information available to investors

According to the survey responses, the main sources of information disclosed to prospective investors during the debt capital raising process are the offering documents (e.g. prospectus for public offerings and offering memorandum for private placements). In many jurisdictions, the requirements governing disclosure of information differ in some respects depending on the types of bonds and the target investors.

That said, some members also pointed out that, regardless of the types of bonds and the target investors, general provisions are in place to ensure that information and marketing communications to investors are true, accurate, complete and not misleading.

Most jurisdictions have laws or regulations governing the disclosure of information where bonds are issued to the public to provide prospective investors with material information necessary to make informed assessments on the issuer and the offering. Information disclosed in private offering documents tends to follow widely adopted practices and are generally similar to, but less comprehensive than, those disclosed in a public offering. Examples of information typically provided in public offering documents include:

- Details of the issuance (e.g. pricing, terms and conditions, rights attached to the securities, and sources and uses of funds raised by the offering);
- Issuer overview (e.g. company profile, ownership and management structure, business description and strategy, sector overview, competitive strengths and challenges and prospects on the issuer and of any guarantor);
- Summary of financial data (e.g. financial positions, assets and liabilities, profits and losses and material contracts); and
- Risk factors associated with the issuer, industry or the offering.

Although not always available, credit ratings of the issuer or the bond itself are a primary source of information for investors. When credit ratings are available, most jurisdictions indicated that investors rely heavily on them to make their investment decision. Credit ratings are often one of the key driving forces for price discovery. One member also commented that credit ratings are often used by investors as a preliminary filter for offerings available on the market (e.g. investors may set a minimum credit rating that a bond must have for them to consider investing).

Most members reported that, unlike equity offerings, connected research¹⁴ does not commonly feature in the traditional bond issuance process. Some members pointed out that there are restrictions related to conflicts of interest and sensitive information.¹⁵ That said, in some jurisdictions, syndicate banks may still write research reports on the issuer of the new bonds in a secondary market context or on the general market or sector. Similarly, non-syndicate banks

¹⁴ Research reports produced by syndicate banks specifically for the bond issuance.

¹⁵ In certain jurisdictions, syndicate firms would cease the publications of all research reports on the issuer during the issuance process once the syndicate firm is mandated a bond issuance.

or independent research providers may produce “unconnected research”.¹⁶

Investors can also access to other available sources of information through the issuers’ audited financial statements, past issuances, as well as recent media coverage and information disseminated and presented by the issuer during a deal roadshow, such as term sheets, fact sheets and credit sheets. However, it is important to note that where unlisted companies issue debt securities, there may be little to no publicly available information for prospective investors.

¹⁶ “Unconnected research” means research that is produced and/ or disseminated by “unconnected analysts” that are employed within firms who are not managing the offering or by independent research providers.

Chapter 4 – Potential risks and harms, and regulatory framework

This Chapter highlights four key risks and potential harms in the debt capital raising process as they relate to the broader issue of conflicts of interest and associated conduct risks. It also covers applicable regulatory frameworks.

Survey respondents indicated that while capital raising processes have common characteristics across different jurisdictions, variations are found in both market practice and the legal and regulatory frameworks governing the processes. This means that the severity of the conflicts of interest and associated misconduct risks and the harm they cause can differ across jurisdictions.

Pricing

There is a potential risk that firms managing a bond offering may be incentivised to price an offering in a way that promotes their own interests (or the interests of their other investor clients), rather than those of the issuer. Such conflicts may result in the under or overpricing of the bonds to benefit other parties at the expense of the issuer. A potential driver of misconduct includes the inherent tension between investors and issuers wanting opposing outcomes from a bond offering (i.e. investors want higher yields whilst issuers want lower yields). For example, conflicts of interest may arise regarding pricing, where an affiliate of the firm, such as its related asset management arm, is also an investor in the bond offering.

Risk Management Transactions

Several survey responses suggested that it is common for issuers, investors participating in the bond issue and the intermediaries to engage in risk management transactions (RMTs) to mitigate the risk of movements in the reference rate between the initial and final pricing or to move between different interest bases. Issuers and investors may enter into interest rate swaps to move between different interest bases (e.g. swap from a fixed to floating rate or vice versa) or enter a rate lock to protect against changes in the level of the reference rate. It is common for the dealing desk of the firm managing the bond issuance to provide these hedging services.

Conflicts of interest could potentially arise from the RMTs causing idiosyncratic movements in the reference rates, which could in turn compromise the integrity and efficiency of both the reference rates and the pricing of the new debt issuance. Where a firm has discretion over whether to undertake these transactions and determine their size or timing, the resulting price may not be in line with either the issuer's or the investor's interests.

Since these transactions are often carried out by the dealing desk of the intermediary firm, managing the bond offering can create a conflict of interest in relation to the pricing of the new offering. This conflict is likely to become more acute when a company is a frequent issuer, given the rapid pace at which these transactions are conducted.

In terms of mitigating the potential for misconduct, most jurisdictions mentioned that a separate department of the firm deals with the RMTs. To achieve this, the firm erects an information barrier between the relevant departments.

More broadly, in most jurisdictions, regulators require firms that manage bond offerings to have effective controls and segregate duties to mitigate potential conflicts of interest that may

arise from its operations.

Legal and regulatory framework governing pricing

Most survey responses noted there are no specific regulatory requirements relating to pricing and risk management transactions. However, there are broader requirements for firms addressing conflicts of interest when managing a securities offering. For example, jurisdictions in the European Union (EU) are now subject to the enhanced MiFID II rules governing the provision of underwriting and placing services. This includes specific requirements for intermediaries in relation to the management of the conflicts of interest inherent in pricing and related RMTs.

Quality of information

As the issuer prepares the offering documents, potential risk and harm could occur if the issuer does not include sufficient details or disclosures to facilitate the understanding of the offering, including the potential impact of risk management transactions if material.

Another risk is that intermediaries do not give an investor sufficient time to read through disclosures and evaluate their decisions. For example, a member jurisdiction indicated that for frequent issuers, the time lapse between ‘announcement’ and ‘pricing’ of a bond issuance can be a matter of hours. And though a debut or infrequent issuer may typically have a two-week period to review the offering documents, it may not be long enough given their likely unfamiliarity with the issuer. Consequently, prospective investors may not be able to digest the offering documents and may have to turn to other sources of information.

While connected research is uncommon for new bond issuances, it could give rise to potential conflicts of interest if produced, primarily because of pressure from various parties on the analysts to write favourable research on the issuer to support the issuance. These parties may include the issuer's management, which is more likely to award mandates to banks or other corporate finance firms employing analysts who are most supportive of the company. They may also include independent corporate finance advisers or even those from within the syndicate bank itself, such as the DCM division which may be pitching for the mandate to manage the issuance. A member jurisdiction commented that the conflict of interest risk may be amplified when investment decisions are typically taken very quickly, particularly on transactions involving a frequent issuer. However, the fact that connected research is rare means that the risk does not appear to be particularly prominent.

There may also be risks to investors associated with information obtained through other available sources. For example, a member jurisdiction pointed out that roadshows may only be attended by invitation, which creates risks of potential discrepancies of information provided to the invited investors and those who are not invited.

There is a general risk that credit ratings may not always be available, especially for bonds that are offered via private placement. Members also pointed out that even when available, credit ratings of the issuer are usually based on past events, limited in scope and reflect only the views of the rating agency at the time the ratings are issued. Therefore, they may change after issuance and not address all material risks related to the investment decision.

The legal and regulatory framework governing quality of information

In general, offering documents for bonds issued to the public and/or listed on exchanges are subject to stringent regulatory requirements (e.g. minimum content disclosures). In contrast, private placements may have more lenient requirements, although they may still be subject to market misconduct or other prohibitions (e.g. making false or misleading statements).

When the offering document becomes available varies depending on whether the issue is public and/or listed or private and whether the transaction relates to a frequent or infrequent issuer. Certain jurisdictions have an “exposure period” of seven days, during which time the issuer is prohibited from processing applications. This is to give the market sufficient time to assess the offer.

Regulation in some jurisdictions specifies how conflicts of interest should be managed during the preparation and distribution of investment research. For example, regulation may typically require segregating the business functions (e.g. corporate finance) from the research function to ensure the independence and objectivity of the analysts’ research and recommendations. This may include physically separating research analysts from the business functions while creating system access barriers that allow only analysts to review draft research reports. In addition, regulation may call for non-public information to be properly managed, prohibit promising issuers favourable research coverage, prevent analysts from participating in investment banking business or pitching for new business and require disclosure of actual or potential conflicts of interest in research reports. In certain jurisdictions, if the corporate finance department of a firm is working on a specific issue, the issuer involved is put on a restricted list and the firm is banned from releasing any research on the issuer during the issuance process.

Allocations

Some member jurisdictions reported that conflicts of interests and associated conduct risks in allocations could arise due to:

- Allocations to investors who have a relationship with the intermediary;
- Allocations to investors who may generate a favourable secondary market for the bond;
- Allocations to other departments of the intermediary such as the trading desk or asset management arm or to a connected entity, which may not be in the best interest of the issuer; and
- Allocations to investors who have contributed to the price discovery process.

Members generally attributed these conflicts to commercial incentives and the intermediary’s multiple service offerings.

Some members made other observations, including the following:

- Inflated orders were not common;

- Grey market trading¹⁷ did not occur or had not been observed; and
- The level of fees and rebates did not pose a risk in allocations because their computation is unrelated to the determination of the allocations in terms of volume.

A small number of members reported that while there was potential for conflicts to arise, market intermediaries effectively manage them through:

- A documented allocations policy;
- Disclosure of interests and relationships to the issuer client and possibly other syndicate members;
- Oversight of the process (including relevant communications) by a control function;
- Documenting and reviewing decisions on allocations, including the reasons for the allocation;
- Regular reviews of the allocations policy and the intermediary's adherence to it;
- Capping of rebates to avoid the preferential allocation of bonds to certain private banking clients; and
- Capping of fees to a maximum percentage of the offer proceeds.

Members reported that additional conflicts of interests and associated conduct risks, may occur when the market intermediary managing the transaction also offers other client services related to the issuance, such as credit facilities, pre-hedging, cross currency swaps etc.

In contrast, some members reported that they had not observed conflicts of interest or associated conduct risks during the allocation process, due to particular features of the allocations process in their jurisdiction, including:

- Allocations of debt securities being facilitated by an electronic booking platform; and
- Notifying potential investors of their allocations criteria alongside other marketing documents.

The legal and regulatory framework governing the allocations process

In many member jurisdictions, the legal and regulatory framework does not contain specific requirements for allocations, although overarching obligations under the general framework may apply, including an obligation to have effective organisational or administrative arrangements and controls to manage potential conflicts of interests.

In contrast, one example of specific laws or regulations is the framework for allocations under the Markets in Financial Instruments Directive (MiFID) II, specifically Articles 38 to 43 of the

¹⁷ Grey market trading is trading that occurs during the period between pricing and allocation of a bond and its admission to the market.

Delegated Regulation (EU) 2017/565. This requires ‘firms’ to:

- Involve the issuer in discussions about the placing process and to obtain the issuer’s agreement to the firm’s proposed allocations;
- Act honestly, fairly and professionally in accordance with the best interest of its clients when providing investment banking or ancillary services to its clients;
- Manage conflicts of interest that arise during the allocations process to ensure allocations are consistent with the issuer’s interests; and
- To have in place a centralised process to identify all potential conflicts of interest arising from other activities of the firm and group and implement appropriate management procedures.

In jurisdictions subject to MiFID II, allocations against the promise of certain considerations are prohibited, including:

- “Laddering” in the form of an allocation made to incentivise the payment of a large amount of fees for unrelated services provided by the firm
- “Quid pro quo agreements” in the form of special commission payments; and
- “Spinning” in the form of allocations of hot offerings (where the value of securities is expected to rise significantly in its opening trading sessions) to company executives to influence the company’s future procurement decisions.

Another member jurisdiction reported that, under its laws and regulations, the lead manager must disclose the total volume of the offering and, where applicable, the amount allocated to groups that have a special relationship with the issuer. The lead manager is also required to disclose the policy used to allocate the oversubscription. Another jurisdiction reported that private banking rebates must be applied to all private banks and their clients consistently, under the existing law and regulation. Other jurisdictions have extensive obligations for listed offerings or offerings to the general public.

Changes to the Legal and Regulatory Framework

Most member jurisdictions reported that they had no plans to modify or enhance their frameworks regarding the identified risks and potential harms.

Chapter 5 – Proposed IOSCO Guidance

This Chapter contains proposed Guidance in the form of eight measures. Each measure is designed to address one or more of the key risks and harms identified in Chapter 4. The Guidance reflects an expectation of high standards of conduct by market intermediaries in the debt capital raising process. The objective is to help regulators and intermediaries avoid and effectively manage conflicts of interest and associated conduct risks in the debt capital raising process.

This report recognises that each jurisdiction determines on its own whether to rely on the guidance as part of their regulatory approach.

Guidance to address conflicts of interest in pricing

Measures 1 and 2 are designed to help ensure that the pricing of an offering does not reflect the firm's own interests or those of its investor clients in a way which conflicts with the issuer's interests. Firms should consider providing the issuer with an opportunity to engage in the decisions and actions that can influence the pricing of the bond offering, which may include providing the issuer with key information relevant to the pricing as the transaction evolves. In addition, regulators should consider if firms should be required to consider the issuer's specific preferences, if any, and whether they relate to any decisions or actions which influence the price.

Hedging strategies and risk management transactions undertaken on the firm's own account or on behalf of its investor clients could give rise to conflicts of interest affecting pricing. Regulators could consider requiring firms to engage with their issuer clients about these transactions to assess the potential impact on client interests.

Measure 1: Regulators should consider requiring firms to manage conflicts of interest that may arise in relation to the pricing of a debt securities offering, keeping the issuer informed of key decisions or actions which can influence the pricing outcome, and giving the issuer an opportunity to express its preference regarding the pricing of an issue during the pricing process.

Measure 2: Regulators should consider requiring firms to take reasonable steps to disclose to the issuer how any risk management transactions it intends to carry out for itself, the issuer, or investor clients, will not compromise the issuer's interests in relation to the pricing of the new issuance.

Guidance to address conflicts of interest in quality of available information

Measures 3 and 4 aim to address any asymmetries in the quality of information that is available to different investor clients. Measure 3 addresses the need for regulators to encourage firms to support the provision of a range of information to prospective investors early in the debt capital raising process, where permitted. This could include, for example, the official offering document as the primary source of information on the issuer during the offering, as applicable.

The aim of Measure 4 is to ensure that analysts' independence and objectivity are not compromised, due to commercial, economic or other incentives of the firm or the analyst. In the context of a firm's pitches to secure a mandate, this measure would prevent analysts within

the firm from being exposed to pressure to develop a favourable view on the issuer.

Measure 3: Regulators should encourage the timely provision of a range of information to investors in a debt securities offering, where distribution of such information is permitted under local law.

Measure 4: Regulators should consider requiring firms to have appropriate controls to identify, prevent where possible and manage any conflicts of interest that arise in the preparation of research on a debt securities offering.

Guidance to address conflicts in allocations

Measures 5, 6, 7 and 8 are aimed at increasing transparency and accountability in the allocations process. In the absence of these Measures, there is an increased risk that the firm will act in its own interests or those of only certain clients. This conduct could potentially compromise the interests of the firm's issuer client and of other clients.

Measure 5 addresses the requirement for, and disclosure to the issuer of, the firm's allocations policy which could include:

- The firm's allocations methodology;
- The extent to which an issuer will be involved in the process, including in final allocations determinations;
- The management of records and review of allocations decisions; and
- The role of the firm's control functions in policy review.

Measure 6 addresses how a firm should account for its issuer client's preferences. In addition to this measure, regulators may also wish to consider encouraging firms to disclose to the issuer when they propose to deviate from the issuer's preferences, including their reasons for doing so, prior to the allocations taking place.

Measure 7 addresses the risk of firms not having appropriate systems and controls in place to manage conflicts of interest when making allocation recommendations.

The final measure on allocations strengthens the firm's record-keeping practices. These could include, if permitted under applicable law:

- The allocation orders received from potential investors;
- Any relevant discussions, instructions or preferences provided by the issuer, other members of the syndicate or the firm itself, on the allocation process; and
- Details of the final allocation made to each investor.

Through these records, firms would typically be able to demonstrate how any conflicts of interests have been appropriately managed to ensure that the issuer's interests have not been compromised.

Measure 5: Regulators should consider requiring firms to maintain an allocation policy that sets out their approach for determining allocations in a debt securities offering, and for the firm to regularly assess its compliance with the policy.

Measure 6: Regulators should encourage firms to consider their issuer client's preferences e.g. investor profile and composition, when making allocations decisions or recommendations.

Measure 7: Regulators should consider requiring firms to have appropriate controls to identify, avoid where possible and manage any conflicts of interest that arise in the allocation recommendations of a debt securities offering.

Measure 8 Regulators should consider requiring firms to maintain records of allocation decisions to demonstrate that any conflicts of interest are appropriately managed.

Chapter 6- Conclusions, questions and next steps

Measures 1-8 and the Guidance

The Guidance set out in this Report is intended to address some potential conflicts of interest and associated conduct risks observed in certain jurisdictions, which can arise at various stages of the debt capital raising process. The Guidance may enhance the:

- Range and quality of timely information that is made available to investors during the process;
- Reasonableness of pricing;
- Transparency of allocations; and
- Efficiency and integrity of the overall process and investor confidence and support capital markets as an effective route for issuers to raise finance.

Question 1: Do you agree that there are conflicts of interest in the debt capital raising process and, if so, what are they? If there are such conflicts, is the Guidance set out in Chapter 5 of this Consultation Report appropriate to address the potential conflicts of interest and associated conduct risks arising in the debt capital raising process?

ANNEX

IOSCO's proposed work on the use of Distributed Ledger Technology (DLT) in the bond issuance process

Context

In May 2018, the IOSCO Board endorsed the creation of IOSCO's Fintech Network to (i) facilitate the sharing of information and expertise amongst its membership during conference calls, and (ii) undertaken substantive work to bring important Fintech-related issues to the attention of the IOSCO Board. In October 2018, the IOSCO Board approved four priority themes suggested by the Fintech Network Steering Group (SG), including distributed-ledger technology. The DLT workstream was therefore created with the goal of producing a series of papers looking at different applications of DLT within a securities market context.

The DLT workstream produced a paper in May 2019 describing the issuance, by the World Bank, of short-term debt using blockchain. In addition, the paper describes, at a high-level, the relevant risks and benefits of such an issuance, explores the regulatory response in the host jurisdiction and considers the potential differences in how different jurisdictions could approach this use case.

As part of its discussions, the DLT workstream wanted to explore to what extent debt issuance on a blockchain platform can reduce any of the conflicts of interest identified by Committee 3 in debt capital raising. For example, it may indeed be possible that the transparency offered by blockchain incentivises syndicate banks to manage their allocation process in a fair manner. Also, DLT could disintermediate some parts of debt capital raising (for example, the book building process) and possibly remove conflicts associated with intermediation.

Question 2: IOSCO is monitoring the digital transformation of the financial industry and has created a dedicated working group to study the integration of new technologies, such as distributed ledgers and blockchain, in the traditional financial process. IOSCO is aware of cases involving debt issued on blockchain platforms and has undertaken a study of the risks and benefits of this technology in the capital raising process.

In your opinion, can distributed ledger/blockchain technology contribute to reducing conflicts of interest in debt capital raising? If so, please explain how.

Question 3: What do you consider the benefits and risks of using the technology in this way?