FICC MARKETS
STANDARDS BOARD

Risk Management Transactions for New Issuance standard for the Fixed Income markets

Final 3 July 2018

I Introduction

1. The FICC Markets Standards Board

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

2. Applicability of FMSB Standards

Each FMSB member firm is expected to confirm annually that it is committed to conduct its FICC market activities (its "Activities") in a manner consistent with the Core Principles contained in FMSB Standards, and to have internal policies, procedures and controls reasonably designed to give effect to those Core Principles where they are applicable to its Activities, in a manner that is commensurate with the nature of its Activities in the relevant entity or jurisdiction. That confirmation is expected to apply to all FMSB Standards issued in final form in the calendar year prior to the year in which the confirmation is made.

The details of FMSB Member firms are available at http://www.fmsb.com.

Standards will be shared with Non-Member firms and their associations, who are encouraged to consider them and conduct their FICC market activities in a manner consistent with them. Information on Standards will be made available to users of the wholesale FICC markets (e.g. corporates and end investors) so that they may be made aware of their existence and FMSB expectation of market conduct.

3. Relationship with law and regulation

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

4. Relationship with other codes

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

5. Transparency Draft Standard

FMSB issued a "Transparency Draft" of the proposed Standard in October 2017 in order to enable all FMSB members and other interested parties to comment on the proposed Standard.

II Risk Management Transactions for New Issuance

1. Explanation

This Standard sets out expected behaviours that are designed to improve the practice and awareness regarding risk management activity that is conducted in and around the new issuance of bonds.

These improvements should enhance the fairness and effectiveness of the process for all market participants.

2. Scope and applicability

This Standard applies to all market participants who are directly involved in Risk Management Transactions (RMTs) that are known by the participant to be linked to syndicated offerings of fixed income bonds in the wholesale primary bond markets in Europe (but subject to any applicable local regulatory restrictions). It is anticipated that it will be adopted by primary markets participants in other jurisdictions over time.

This Standard is not intended to cover practices relating to auctions and buybacks of sovereign, supranational, or corporate debt, or issuance of securitised debt or commercial paper.

For the purposes of this Standard, Risk Management Transactions ("RMTs") are trades that are executed by issuers of fixed income bonds by way of syndicated offerings in the wholesale bond markets in Europe ("Issuers") and investors in such bonds ("Investors") with Dealers (as defined below) to manage interest rate, inflation and foreign exchange risks arising from their direct involvement in the issuance process, whether as Investor in, or Issuer of, the new bond. Market participants include Issuers, Investors and Dealers who are active in the wholesale fixed income markets during a new issue period.

The Standard applies to any Dealers who execute RMTs with Issuers or Investors when the RMT in question is transacted sufficiently proximate in time to the pricing call so that it, or the hedging of that RMT, might reasonably be expected to be capable of influencing the Reference Rate or Reoffer Yield of the New Issue, and:

a) The Dealer is a member of the syndicate for the new issue and its trading desk responsible for transacting the RMT in question is aware that the RMT is directly related to the new issue, or

b) The Dealer is not a member of the syndicate for the new issue but its trading desk responsible for transacting the RMT in question is aware that the RMT is directly related to the new issue.

III Interest rate risk management activity for New Issuance

1. Issuance Process

New primary issuance of fixed income instruments ("new bond issuance" or "new issue") follows a process that is presented below at a high level. Further details of the new bond issuance process and principles that apply can be found in the New Issue Process Standard for Fixed Income Markets.

- Mandate stage
- Marketing stage
- Execution stage
- Post-launch stage

New issues are typically brought to market by a syndicate of banks (a "Syndicate"). At the execution stage the Syndicate will, on a best efforts basis, build a book of potential investors interested in purchasing the new issue, and such book will be of a sufficient size and type in order to achieve the funding aims of the Issuer. Once the new issue has priced and the book finalised, the Issuer and the Syndicate will execute an underwriting agreement to ensure the Issuer can issue securities for the entire nominal amount and receive proceeds accordingly.

2. Rationale for risk management activity

Origination of market risk in the issuance process

The coupon and issue price for the prospective new issue are typically calculated from the Reoffer Yield (the yield at which the new issue is reoffered to Investors by the Syndicate). The Reoffer Yield is calculated as a credit spread specific to the Issuer over a Reference Rate (including but not limited to a swap rate or the yield on an asset such as a government bond or similar corporate credit, or a benchmark such as Libor).

The actual coupon and issue price for the new issue will be determined by calculating the Reoffer Yield when the market observation of the Reference Rate is agreed during the pricing call.

Issuer: Once the Issuer has decided to launch the new issue, they have the risk that a) the Reference Rate will change, and b) the spread at which they can issue relative to the Reference Rate will change, before the new issue is priced. Either of these changes will alter the pricing of the new issue.

The Issuer may decide to alter the risk profile of the issuance proceeds into a different format to suit their actual funding needs or to manage their liability profile (e.g. issues in fixed rate USD but where the Issuer requires floating rate EUR).

Investor: Once the new issue is announced and Investors have decided to purchase bonds, Investors in the new issue have the risk that the Reference Rate or spread to the Reference Rate will change before the issue is priced. Either of these changes will alter the pricing of the new issue.

The Investor may decide to switch out of their existing debt holdings in order to purchase the new issue (e.g. sell holdings of 12-year Issuer debt for newly issued 15-year Issuer debt), or to otherwise hedge their holding in the newly issued bond to suit their specific investment requirements.

3. Types of Risk Management Transactions

The sections below provide the most typical examples of RMTs but due to variations in the underlying transaction or the execution methods of RMTs related to new issues, this is not an exhaustive list.

Risk Management Transactions by the Issuer to hedge against movements in the Reference Rate

In order to manage the risks associated with movements in the Reference Rate of a new issue, Issuers may undertake RMTs to lock in a funding rate or a funding spread. These transactions are typically entered into before, or around, the time that the Issuer is deciding on which Dealer to mandate for the new issue, and unwound at, or in close proximity to, the time of pricing of the new issue. The types of RMT used include:

a) **Rate Lock**. A Rate Lock may be used to provide the Issuer with a hedge against changes in the level of the Reference Rate against which the new issue is priced. This provides the Issuer with protection against a rise in the Reference Rate.

b) **Spread Lock.** A Spread Lock may be used to provide the Issuer with a hedge against the basis between an asset and swap rate, for example the spread between a government bond and swap of the same maturity. This therefore provides the Issuer with mitigation against a movement in the basis spread.

Risk Management Transactions by the Issuer to alter funding profiles

Issuers may enter into RMTs to change the liability profile of their new issue to one that conforms with their preferred funding needs. These transactions are typically entered into at, or in close proximity to, the time of pricing of the new issue. The types of RMT used include:

c) **Liability Swap**. Issuers may enter into interest rate or inflation swaps to change their future interest rate liabilities, for example, from fixed to floating. The interest rate swap may be linked to the Reference Rate of the new issue, or may be linked to a different rate but one that is related to the Reference Rate, as required by the Issuer.

d) **Cross-Currency Swaps**. Issuers may enter into cross-currency swap agreements to swap the new issuance proceeds from one currency to another, and to mitigate potential cross-currency risk arising from future cash flows, e.g. issues in fixed rate USD where floating rate EUR is required.

Risk Management Transactions by Investors

Investors often enter into RMTs at the time of pricing of a new issue, but may exercise some discretion with respect to this timing. RMTs are typically executed at spread terms agreed with the Dealer ahead of the time of trading at the pricing of the new issue. The types of strategies used include:

e) **Switches**. Investors may seek to exchange an existing holding of bonds to invest in the new issue.

f) **Hedging**. Investors may seek to simultaneously purchase the new issue with a RMT (interest rate, inflation or cross currency swap) to change the cashflows from the new issue to terms that better suit their investment requirements.

4. Conduct risks created by Risk Management Transactions

The following are the key risks associated with the use of Risk Management Transactions that the Core Principles in Section IV are intended to mitigate:

- The execution of RMTs and the management of corresponding hedging activity may influence the Reference Rate.
- The selection and formation of the Reference Rate could be conducted in a way that does not promote fair treatment to investors, issuers and other market participants.
- Material Non-Public Information ("MNPI") about new issuance, or related RMTs could be inappropriately shared with internal or external parties.

Market participants will not have complete knowledge of all the RMTs that are transacted, and the market activity that will occur, in and around the pricing window, and the corresponding effect that these could have on observable prices, including the Reference Rate. Nevertheless, market participants need to have regard to the potential impact their trading might have in and around the pricing window in the manner described in this Standard.

There are a number of scenarios that can occur based upon the types of RMTs that Issuers and Investors choose to use, and the way in which these may affect the economics of the bond issue.

Issuers may choose to:

a) not hedge,

b) hedge at the point of pricing, or

c) hedge before issuance and unwind at the point of pricing.

Investors may use RMTs to hedge or alter their exposure to the issue, or alternatively may purchase the issue unhedged.

The table below shows three core example scenarios:

Scenario	Description	Example risks & conflicts of interest
Issuer does not hedge issuance	New issue comes to market and is unhedged by the Issuer.	• The Issuer is exposed to changes in the Reference Rate. • Investor activity in the secondary cash or derivative markets could influence the Reference Rate, to which the Issuer is exposed. • The Dealer may have to manage and hedge the demand from Investors for RMTs. • The Investor may be exposed to changes in the Reference Rate depending on their use of RMTs.
Issuer hedges at point of pricing	Issuer may use an RMT to change its future liabilities. The RMT may be priced off the same Reference Rate as the Issuance or a related rate.	• The Issuer is not exposed to changes in the Reference Rate depending on their choice of RMTs. • The Investor may be exposed to changes in the Reference Rate depending on their use of RMTs. • Hedging activity by the Dealer prior to the pricing call may influence the Reference Rate to which unhedged Investors are exposed. • The Dealer may have to perform hedging in a concentrated timeframe due to Issuer RMTs and demand for RMTs from Investors.
Issuer hedges before the point of issuance and unwinds the hedge at the point of pricing	A pre-existing hedge (e.g. rate or spread lock) was used by the Issuer and is unwound at the pricing call.	• The Issuer is not exposed to changes in the Reference Rate depending on their choice of RMTs. • The Investor may be exposed to changes in the Reference Rate depending on their use of RMTs. • Rebalancing of hedges by the Dealer prior to the pricing call may influence the Reference Rate to which unhedged Investors are exposed. • Dealer may have to perform hedging in a concentrated timeframe due to unwind of Issuer RMTs and demand for RMTs from Investors.

IV Principles and Commentary

This Standard sets out a number of Core Principles relevant to RMTs for new issues in the fixed income markets, together with commentary explaining their rationale.

a) Selection of the Reference Rate

> ***Core Principle 1:*** *The Reference Rate for any new bond issue within scope of this Standard should be selected on the basis of objective criteria, should be a rate that meets the requirements of the Issuer, and be explicitly agreed with the Issuer.*

> ***Core Principle 2****: The Reference Rate selected should be observable and transparent, or calculable from information that is observable and transparent, to other market participants.*

Typically, the Reference Rate will be chosen by the Issuer following discussions with and guidance from the Syndicate. The choice of the Reference Rate for the new issue should be agreed with the Issuer as part of the documented strategy for the transaction as described in the commentary to Core Principle 1 of the New Issue Process Standard for the Fixed Income markets.

Pricing of RMTs entered into by the Issuer or Investors may be directly linked to the instrument informing the Reference Rate of the new issue, or directly linked to similar or correlated instruments.

Please see section IV.c below for a more detailed discussion of the effect that the hedging of RMTs may have on the Reference Rate.

b) Formation of the Reference Rate and Reoffer Yield

> ***Core Principle 3****: Potential conflicts of interest inherent in the formation and observation of the Reference Rate and Reoffer Yield, and relevant activity, should be managed by Dealers in a way that promotes fair treatment of Investors, Issuers and other market participants.*

Dealers should be aware of and manage the possible conflicts of interest related to the formation and observation of the Reference Rate and Reoffer Yield used for the new issue or in RMTs.[1]

Please see section III.4 for a more detailed discussion of potential conflicts of interest.

[1] Market participants subject to MiFID II in the EU should note Article 39 of the MiFID II Organisational Requirements and Operating Conditions for Investment Firms delegated regulation (EU/2017/565).

c) Hedging

> ***Core Principle 4****: Potential conflicts of interest inherent in the hedging of market risk arising from the new issue process, and relevant activity, should be managed by Dealers in a way that promotes fair treatment of Investors and Issuers.*

Please see section III.4 for a more detailed discussion of potential conflicts of interest.

> ***Core Principle 5****: Dealers should manage their hedging of RMTs such that it is solely aimed at risk mitigation and is never performed for the purpose of influencing or manipulating the Reference Rate or Reoffer Yield.*

Since a RMT entails a risk transfer, the liquidity provider of that risk (the Dealer) will at its discretion hedge that risk, and this hedging activity can take place before, during or after the pricing call of a new issue. Hedges executed before or during the pricing call could exert market pressure on the Reference Rate used to price the new issue, and thus affect the Reference Rate

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

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

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

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

> ***Core Principle 6**: Where of RMTs takes place at portfolio level, the management of a Dealer's aggregate position should be consistent with this Standard.*

Dealers will be facilitating other client transactions, or managing their own risk positions. These activities are usually undertaken on a portfolio basis, and so it is not required, and would be difficult, to assign individual hedging transactions to individual RMTs. Nonetheless Dealers should ensure that the management of their aggregate position is consistent with this Standard.

d) Investor and Issuer activity

> ***Core Principle 7:** Investors and Issuers should not execute RMTs for the purpose of influencing the Reference Rate or Reoffer Yield or attempt to otherwise influence the Reference Rate or Reoffer Yield at the time of pricing.*

Please see section III.4 for a more detailed discussion.

e) Disclosure

> ***Core Principle 8:** Dealers should make Investors and Issuers aware of the key mechanics of RMTs, in particular the fact that hedging can take place before, during or after the pricing call, by making clear in the relevant terms of business or otherwise by disclosure to the client that the Dealer observes FMSB Standards, or by express disclosure in some other way.*

This Standard describes the key mechanics and risks in the new issuance process connected with RMTs and related hedging transactions. As such, this Standard may be used as an information document for Investors and Issuers for the purposes of Core Principle 8.[2]

[2] Market participants subject to MiFID II in the EU should note Article 39 of the MiFID II Organisational Requirements and Operating Conditions for Investment Firms delegated regulation (EU/2017/565).

f) Restrictions on internal and external dissemination of information

> ***Core Principle 9:*** *Information about any RMTs should remain confidential to the transacting parties subject to complying with applicable laws and regulations, satisfying reporting requirements, and disclosing details to the extent necessary for execution, processing or settlement of that RMT.*

Distribution of appropriately aggregated and anonymised information by a market participant is acceptable provided such distribution does not have the potential to impact any pending RMTs of which the market participant is aware.

Dissemination of information to market participants for the purpose of hedging a RMT should be undertaken in a manner designed to minimise the risk that market participants infer information about the RMT (or the new issue to which it relates), unless the client is aware that such information may be shared for hedging purposes.

> ***Core Principle 10:*** *Dealers should ensure that they have implemented policies and procedures for managing MNPI, and that any MNPI relating to a new issue or RMT is managed in accordance with those policies and procedures.*

g) Monitoring, controls and training

> ***Core Principle 11:*** *Market participants covered by this Standard should have processes and record keeping to monitor RMTs to reasonably ensure compliance with the Standard. The processes should include an escalation process for addressing concerns identified by traders or their supervisors in connection with the trading and hedging of RMTs.*

> ***Core Principle 12:*** *Firms should ensure that their personnel are trained on the substance of the Standard and their responsibility to identify and escalate non- adherence to firm policy and procedure around the new issue process internally.*