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SFC consultation paper on new requirements for equity and debt bookbuilding and placing activities

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On 8 February 2021, the Securities and Futures Commission (SFC) issued a consultation paper on proposed conduct requirements for capital market transactions in Hong Kong. The proposed requirements are designed to strengthen the Hong Kong capital markets by clarifying the roles played by intermediaries in equity and debt capital raisings and setting out the standards of conduct expected of them in bookbuilding, pricing, allocation and placing activities.

What are the issues that the SFC is aiming to address?

The SFC's thematic review of licensed intermediaries engaged in equity capital market (ECM) or debt capital market (DCM) activities and engagement with both buy-side and sell-side participants focused on the state of the market, as well as the practices and conduct of intermediaries.

The thematic review identified the following issues with current market practices:

- **Lack of clarity on the roles and responsibilities of intermediaries engaged in capital raising in Hong Kong,** which can be confusing to buy-side firms and may result in a lack of accountability for the conduct of an offering.
- **Deviations from accepted market practices on syndicate membership and fee arrangements**, where more issuers were adopting the late determination of fee arrangements, therefore incentivising sell-side firms to compete more aggressively to join a syndicate, often at a late stage in an offering. This in turn has led to latecomers being unfamiliar with the issuer and the offering and, as a result, being unable to market the offering properly. A focus by syndicate members on **order quantity over order quality** places greater emphasis on price-insensitive demand when building the book, which can then be used to drive up the price of an offering to a level desired by the issuer, but not sustainable in secondary market trading.
- Placing by intermediaries of orders in the order book which they know have been inflated (so-called **knowingly inflated orders**) which undermines the price discovery process and can mislead investors.
- **Lack of transparency in the order book** resulting from the use of "x-orders" where the identities of investors are concealed, preventing the heads of syndicate from assessing real demand or identifying unusual or irregular orders.
- **Preferential treatment or rebates paid to investors** including cases where rebates paid to private banks in DCM transactions are passed on to the private banks' clients, undermining the fair treatment of investors as different investors in effect pay different prices for the same debt securities. Another example is syndicate members rebating brokerage fees to IPO investors with the result that these investors will pay a lower price for shares than others.
- **Lack of written documentation by heads of syndicate** to establish the position in case of any dispute to facilitate the SFC's assessment of intermediaries' compliance with regulatory requirements.

Who will be affected?

The proposed code of conduct applies to Capital Markets Intermediaries (CMIs) engaged in the following in relation to a share or debt offering:

- Bookbuilding activities (including price determination, allocation and the process of assessing demand);
- Placing activities; and
- Advising, guiding and assisting the issuer in bookbuilding and placing activities.

CMIs do not include financial advisers or other professionals who only provide advice to the issuer (e.g. on pricing or marketing strategy) but do not participate in any bookbuilding or placing activities.

When will the new requirements be effective?

The consultation period ends in May 2021, and while there is no timeline on implementation, the SFC has stated that it will give **a six month implementation period**.

What are the proposed new requirements?

Proposed Code of Conduct to address specific problems in intermediary behaviours and to codify best practices	The SFC proposes to issue a new section to the Code of Conduct which will apply to intermediaries conducting bookbuilding and placing activities in Hong Kong, defining the intermediaries involved in these activities as CMIs and further defining the overall coordinator (OC) as the head of syndicate by the activities it conducts (such as the overall management of an offering, coordination of bookbuilding or placing activities conducted by the syndicate and the provision of advice to the issuer). The revision to the Code of Conduct will set out the standards of conduct expected of CMIs, covering a wide spectrum of activities, including bookbuilding, allocation and placing, to address issues including inflated or opaque demand, preferential treatment and rebates, misleading “book messages”, proprietary orders which may negatively impact on the price discovery process, and orders which conceal the identities of investors. Since OCs play a lead role and shoulder greater responsibility, they would be subject to additional conduct requirements, for example, in advising the issuer of pricing, allocation and marketing strategies. The revised Code of Conduct will also require that syndicate membership and fee arrangements (including the fixed fees and fee payment schedule) be determined at an early stage. It also requires formal appointments of CMIs through written agreements specifying the roles and responsibilities and fee arrangements, to enhance accountability among syndicate CMIs and discourage undesirable behaviours. The proposed code sets out a timeframe within which fee arrangements should be determined and requires related disclosures to be made to the SFC.
Introduction of “Sponsor Coupling”	The SFC is proposing “sponsor coupling” which, in broad terms, would require that for IPOs at least one sponsor should also be appointed as an OC or should have a group company appointed as OC, ensuring that: • at least one sponsor would be free of potential incentives to limit due diligence in order to secure an OC role; • the Sponsor OC should be in a position to give comprehensive advice to the listing applicant throughout the transaction; and • buy-side participants can look to the Sponsor OC to provide well informed and authoritative answers to their questions.
New record keeping requirements	The SFC proposes to require CMIs to maintain books and records, including documenting key communications and audit trails of key decisions, as well as documenting all changes in the orders in the order book throughout the bookbuilding process and all key discussions with, and key advice or recommendations provided to, the issuer.
Monitoring and surveillance	The SFC also proposes to introduce a new requirement to extend surveillance and monitoring to cover ECM and DCM activities including conduct independent surveillance and monitoring on a regular basis to detect irregularities, conflicts of interest and leakage of price sensitive or confidential information, as well as potential non-compliance with applicable legal and regulatory requirements or its own internal policies and procedures.

These requirements are likely to require CMIs to undertake **comprehensive reviews of existing policies, procedures and internal controls** to ensure compliance with the new requirements when they become effective. Existing processes are often manual in nature and lack system-enforced controls. **Reliance on existing tools such as excel spreadsheets or email-based audit trails and approvals is likely to present significant risks of non-compliance.** We expect these requirements to be an area of focus for the SFC in future inspections of capital markets participants, and therefore recommend that CMIs **carefully consider the adoption of automated workflow solutions and other technology tools** which can enable them to better ensure full compliance with the new requirements. Adoption of robust workflow tools and other ‘Regtech’ solutions can help to ensure:

- Audit trails are maintained in line with new requirements including complete evidence of required approvals and sign-offs; and
- Potential cases of non-compliance are quickly identified through automated monitoring and surveillance.

How can KPMG help?

KPMG can provide CMIs with assistance in conducting gap analyses and the implementation of the proposed requirements. KPMG is well-placed to provide support in areas including but not limited to:

Impact analysis

- Conducting awareness and knowledge training across business lines and functional groups.
- Performing impact analysis of the proposed requirements. The impact analysis can cover:
  - Operations, systems and infrastructure;
  - Internal controls and processes; and
  - Policies and procedures.
- Identifying any systems, operations, controls, policies and funding gaps in order to fulfill the requirements of the proposed requirements.
- Identifying opportunities to achieve efficiencies and cost savings through the automation of processes and controls.

Implementation

System tools

- Selection of the right technology based on your application landscape
- Build, test and implement a technology-based workflow application in your production environment
- Design/implement user friendly intuitive user interface to capture information in real time
- Assist in the design and implementation of flexible platforms which can easily integrate with technologies like AI, NLP and OCR

Internal controls and processes

- Assist in designing and implementing controls and processes to ensure compliance with the new requirements
- Embed controls in workflow processes which ensure the completeness of information through automated alerts and checklists
- Enhance visibility through better reporting and transaction level information
- Design/implement automated monitoring and surveillance to meet new requirements

Framework & policy

- Assist in reviewing and enhancing the existing policies for bookbuilding and placing activities business
- Provide advice on optimal roles and responsibilities across the three lines of defence

Post-implementation

- Perform post-implementation reviews of enhanced policies, procedures and internal controls
- Perform independent assessments of suspected breaches of the new requirements

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