FICC MARKETS STANDARDS BOARD

Statement of Good Practice for Participation in Sovereign and Supranational Auctions in Fixed Income Markets

Transparency Draft

December 2019

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, Currencies and Commodities ("FICC") markets. The FMSB will work to build up a body of Standards ("Standards") and Statements of Good Practice ("SGPs") over time, prioritising those areas where FMSB member firms ("Member Firms") 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 Statements of Good Practice

FMSB SGPs are issued by the FMSB from time to time. SGPs do not form part of the FMSB Standards and they are not subject to FMSB's adherence framework. Rather, they reflect FMSB's view of what constitutes good or best practice in the areas covered by the SGPs in question. Member Firms are expected, and other firms are invited, to consider their own practices in light of the relevant SGP and make any changes to such practices that they deem to be appropriate. Failing to do so will not, however, create any presumption or implication that a firm has failed to meet its regulatory or other obligations.

Full details of the Member Firms are available at https://fmsb.com: FMSB. SGPs will be shared with non-member firms and their affiliates, who are encouraged to consider them. Information on SGPs 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 the FMSB's expectation of market conduct.

The FMSB will, as part of its normal course of business, periodically review the applicability of its published SGPs to ensure they are relevant and up to date for market conditions.

3. Relationship with law and regulation

FMSB Standards and SGPs do not impose legal or regulatory obligations on Member Firms, nor do they take the place of regulation. In the event of any inconsistency, applicable law, rules and regulation will prevail. In developing Standards and SGPs, certain relevant regulators will in many cases have commented on their drafting, alongside Member Firms and other bodies, such that the Standards and SGPs, 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, such as the FX Global Code, whilst others are in the process of being produced. There will be some overlap between the work of the FMSB and such 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 or SGP where the subject matter is already covered adequately by existing regulation or a Code issued by another body. It may draw attention to Member Firms of an existing code and request that Member Firms act in a manner consistent with it, once appropriate steps have been taken to confirm its applicability.

II Background

1. Introduction

A common way for government or supranational bonds to be issued is through a publicly announced auction. Auctions involve multiple parties / participants including Issuers (debt management offices/agencies/treasuries), Primary Dealers, Dealers and Investors.

Part III of this SGP describes the way in which sovereign and supranational auctions are typically conducted in Europe, the roles Market Participants in those auctions play, the types of auction structure, orders and transaction types that are often utilised, and the different conflicts of interest that can arise for such Market Participants.

Part IV sets out a number of Good Practice Statements relating to the management of those conflicts and certain other matters relevant to the conduct of participants in and around such auctions.

2. Scope and applicability

This SGP applies to Primary Dealers, Dealers and Investors, as described in Part III, in the wholesale Fixed Income markets who participate in pre-announced multi-lateral auctions and reverse auctions conducted by issuers of government and supranational bonds in Europe (but subject to any applicable local regulatory restrictions), referred to in this SGP as "Market Participants".

III Sovereign and Supranational Auctions

1. Market Participants

a. Issuers

Issuers are Government and Supranational entities who issue debt securities to finance their operations (“Issuers”). This will generally be through a debt management office, treasury or finance office. For example, the UK Debt Management Office, Dipartimento del Tesoro in Italy or the Netherlands Dutch State Treasury Agency.

b. Primary Dealers

A “Primary Dealer” is a financial institution that is appointed by an Issuer to buy, promote and distribute government bonds pursuant to an agreement or other document (a “Primary Dealer Agreement”) which sets out the obligations of the parties. Some issuers (e.g. Federal Republic of Germany) do not refer to the financial institutions appointed as Primary Dealers but the structure under which they operate remains similar. For the purposes of this SGP we will refer to Primary Dealers to capture any party which fulfils this role, regardless of the local terminology.

The obligations on Primary Dealers differ depending on the particular Issuer and the terms of their Primary Dealer Agreement. Issuers may require:

- support by the Primary Dealer in respect of the product liquidity, including:
    - participation in secondary market trading as well as any minimum quoting obligations; and
    - supporting a fair and effective market.
- the provision of information, including:
    - the promotion of a specific bond market through analysis, research and publications; and
    - the provision of information / data about primary and secondary market investor participation to Issuers.
- the participation by the Primary Dealer in government bond auctions including a minimum participation level (the minimum participation level typically refers to the minimum total amount that a Primary Dealer is obliged to bid at auction).

The rights and privileges of Primary Dealers set out in a Primary Dealer Agreement can differ but may include:

- the right to participate in auctions and syndications of bonds;
- the right to participate in buy back and exchange transactions;
- preferred status in debt and liquidity management operations; and
- access to any post auction option facility and/or non-competitive subscription during the auction. Some Issuers make a subscription of bonds available after the auction to Primary Dealers. The mechanism for pricing these differs from Issuer to Issuer.

A Primary Dealer is, through its Primary Dealer Agreement, obliged to participate in bond auctions and bid for paper.

The Association for Financial Markets in Europe (AFME) compiles a handbook from public information that provides a general guide for Primary Dealers to better understand the different Primary Dealership systems in place in Europe. This is periodically updated and can be found on www.afme.eu/Portals/0/globalassets/downloads/publications/afme-primary-dealers-handbook-q3-2017-3.pdf.

c. Dealers

For the purpose of this paper a “Dealer” is a market maker or liquidity provider authorised to deal in debt securities who is not a Primary Dealer, but who is active in trading in debt securities issued pursuant to auctions, for themselves and/or for their clients.

d. Investors

For the purpose of this paper an “Investor” is a participant in debt securities in the primary and/or secondary market investing for their own account or for the account of their underlying clients. Example of Investors include: hedge funds, asset managers, pension funds, corporate treasuries (including bank treasuries), central banks and sovereign wealth funds. Investors will typically be clients of Primary Dealers and Dealers.

2. Auction Types

a. Types of Auction Price Forming Mechanisms

Auction arrangements can vary from Issuer to Issuer. The size of an auction, the bond(s) being offered and the disclosure of either of these items also varies depending on the Issuer. Notwithstanding these variations, there are three main auction price forming mechanisms that are operated in Europe for new and existing bonds:

i) Dutch Auction System or Uniform Price Auctions

This system satisfies bidders (i.e. Primary Dealers) at the same auction price, which is commonly referred to as: the single price; the cut-off price; the uniform price; or the marginal price. The auction price is set after taking in all competitive bids (which may be specified by price and size or yield and size). The highest bid at which the offering can be fully sold is determined and this is set as the auction price. The usual mechanism for determining the auction price is through allocating the bids, beginning with the highest price and completing the allocation when the aggregate sum of the allocations reaches the specified issuance amount. The price of the last bid to be satisfied establishes the auction price, hence being referred to as the “cut-off” price. All bids submitted at prices higher than the cut-off price are allotted for their full amount at the cut-off price. Bids at the cut-off price may be subject to pro rata curtailments to provide for a precise representation of the scheduled competitive issue size.

ii) Multi Price or Competitive Auction

In this system bids are ranked in accordance with the respective bid price in a descending order. The Issuer accepts the bid with the highest price first until the issuance amount has been allocated completely. The bid price of the last admitted bid in this process is referred to as the marginal price, or the cut-off price. Above the cut-off, bids are accepted at their respective bid prices, i.e. there is no uniform price and bidders pay different prices. Bids at the cut-off price may be subject to pro rata curtailments to provide for a precise representation of the scheduled competitive issue size. A competitive price auction discriminates between auction bidders as some pay more than others.

iii) Hybrid Auction

This system combines elements of the Uniform Price Auctions and Multi-Price Auctions described above, although the exact dynamics can differ. Typically, the submitted bids are ranked in price descending order. As with the Multi-Price Auction, the Issuer accepts the bid with the highest price first until the issuance amount has been allocated completely. The price of the last allocated bid in this process is referred to as the marginal price. All bids above the marginal price are accepted. Bids made at the marginal price are either filled at the marginal price or may be subject to pro rata curtailments to provide for a precise representation of the scheduled competitive issue size. The bids submitted between the marginal price and the weighted average of all bids greater than the marginal price (commonly referred to as the "weighted average price") are filled at the relevant bid price. The bids submitted above the weighted average price are filled at the weighted average price, i.e. the weighted average price is the highest price any bidder pays.

By way of illustration of the differences between the above auction types, the outcomes in respect of a worked example are set out below:

Example: Auction Size 100MM

		Allotted Price			
Bid Size (MM)	Bid Price	Multi Price /Competitive	Dutch/Uniform	Hybrid	
25	100.15	100.15	100	100.0725	
20	100.1	100.1	100	100.0725	
30	100.05	100.05	100	100.05	
25	100	100	100	100	
40	99.95				[Bid below cut-off]

Lowest Accepted Price (LAP)	100
Weighted Average Price (WAP)	100.0725
Highest Accepted Price (HAP)	100.15

Some Issuers offer a post auction facility whereby successful bidders in an auction are offered the right to purchase an additional percentage of the bonds they bought at the relevant auction at the published average (or lowest accepted) price. The facility is usually open for a specified time period and allows a Primary Dealer to specify whether they wish to take up some or all of their entitlement both for themselves and where available for Investors who have participated in the auction. Such post auction facilities are used irrespective of which of the price forming mechanisms listed above is used.

b. Other Auction Characteristics

Additionally, auctions can also be characterised in the following ways which could take any one of the price forming mechanisms described in (a) above.

i) Tap

A tap issue allows Issuers to sell additional bonds from past bond issuances that have not yet matured thereby increasing the amount of bonds in issuance. The bonds are issued at their original face value (nominal amount), maturity and coupon rate but are sold at the prevailing market price.

ii) Switch

Switch operations are a process that allows Investors to exchange a particular bond or set of bonds (often not the most recent bond in issuance / off-the-run) with a selection of the most recent / on-the-run bonds at market price. Switch operations may also be used by Issuers for the purpose of redemption management. When a switch takes place through an auction format the Investor would usually specify an amount of bonds and a conversion ratio with which to switch the old bonds into the new bonds.

iii) Reverse

A reverse auction is an auction in which the roles of the buyer and seller are reversed. It is an auction in which an Issuer wishes to repurchase bonds and requests for Investors, Dealers and/or Primary Dealers to offer prices at which they are willing to sell their bonds back to the Issuer typically through the Primary Dealer.

3. Investor Transaction Types

Clients make enquiries to purchase bonds at the time of an auction. These enquiries may be motivated by increased liquidity at the time of the auction. The enquiries can be in the form of indications of interest, orders or reference price transactions.

Below are examples of different order or transaction types that allow Investors to purchase bonds linked to an auction.

i) Direct orders to participate in the auction

There are two types of direct orders which an investor may make in order to participate in the auction:

a. A “Fixed Price Order” or “Competitive Order” allows an Investor to provide a fixed price to a Primary Dealer or a Dealer to be used as the bid price, which shall be filled only if the auction price is below the fixed bid price specified by the Investor. The order may or may not be entered into the auction book by a Primary Dealer. In some cases, the name of the Investor is identified to the Issuer in the bid entered through the relevant auction system e.g. UK DMO currently requires this. The Investor may or may not get filled in this transaction.

b. Some DMOs offer a “Non-Competitive Order”, which allows an Investor to submit an order to a Primary Dealer such that the investor accepts being filled at the average clearing level of the auction, but the quantity filled is set at the discretion of the Issuer and typically varies by auction. All Non-Competitive Orders at an auction receive the same allocation percentage and same price.

ii) Reference Price Transactions

“Reference Price Transactions” or “RPTs” are secondary market bilateral transactions between an Investor and a Dealer or Primary Dealer where the Investor’s transaction is executed by reference to the outcome of the relevant auction, (the “reference price”), for example, the weighted average price of the relevant auction (or a spread to such price) which would be commonly referred to as an “Average Price Order”. An Investor may request a reference to a different outcome. The fill is guaranteed by the Dealer or Primary Dealer in this transaction.

For more information related to RPT’s see the FMSB’s Standard on Reference Price Transactions in the Fixed Income Markets.

Both Fixed Price Orders and RPTs may be traded at a premium or a discount to the price specified. For example, either Dealers or Primary Dealers may offer Investors a spread to a Reference Price Transaction that acts as a discount to the reference price. Any discounts or premiums offered should adhere to applicable law or regulation as well as to any rules of a particular Issuer. For example, in the context of Fixed Price Orders in the UK market, where investors participating in the auction submit their bid to a Primary Dealer of their choosing, such Primary Dealer is required to submit the bids it receives from investors to the UK DMO without charge or discount (which would be commonly referred to as “discount orders”).

4. Conflicts of Interest

The interaction between the different roles and objectives of Market Participants, the Issuer's chosen price formation mechanism, type of auction system and differing transaction types can lead to conflicts of interest for the Market Participants. These conflicts of interest may lead to behaviours that may be detrimental to fair and effective markets (as well as potentially breaching applicable law or regulation).

For information relating to conflicts of interest more generally, see the FMSB's Statement of Good Practice on Conflicts of Interest.

The below section attempts to identify and explain some of the key conflicts of interest that can arise for Primary Dealers and Dealers.

i.) Primary Dealers have a number of competing interests:

a. to meet their obligations to the Issuer under the relevant Primary Dealer Agreement
b. to secure credit with the Issuer for future issues through other mechanisms (e.g. Syndications)
c. to help Investor clients who are participating in the auction to purchase bonds
d. to purchase bonds through successful bids for their own account in the auction
e. to provide secondary market liquidity in and around the time of the auction
f. their own commercial objectives to maximise performance of their business to generate revenue

ii.) These competing interests can conflict with each other. For example, where a Primary Dealer has knowledge of Investor client orders this could influence the Primary Dealer's bidding strategy in the auction, in a way which is detrimental to that Investor or other Market Participants. If an Investor client places a Fixed Price Order with a Primary Dealer with specific instructions for it to be entered into the auction, a Primary Dealer may then adjust its own bidding in order to ensure its orders are filled ahead of the Investor client's order. This asymmetry of information can lead to the Investor client's price not being met when the auction concludes. Additionally, an Investor client may not be aware of how a firm handles a Fixed Price Order and whether it is entered directly into the auction or managed by a Primary Dealer through secondary market trading activity.

iii.) Dealer statistics may be a consideration both for the Issuer and the Investor in relation to future business. As such there is an incentive for Primary Dealers and Dealers to participate on behalf of an Investor client.

iv.) Exposures created by Reference Price Transactions, depending on materiality and the risk profile of the Primary Dealer, may incentivise the Primary Dealer to act in a manner that could be detrimental to Investors and/or the Issuer through different forms of market misconduct by creating a bidding profile that alters price, depending on the auction mechanics.

v.) Secondary market activity by Dealers and Primary Dealers can be a mechanism for influencing the settlement price of auctions. A bond being auctioned will have some level of correlation to bonds already in issuance or in the case of a tap auction can be the same bond. As such, activity in the secondary market can impact the price of bonds and ultimately where Investors and Primary Dealers place their bids in auctions.

Both Dealers and Primary Dealers could be motivated to trade in the secondary market in order to impact the outcome of a specific auction to their advantage. This risk is likely to be more pronounced for Dealers given that, in contrast to Primary Dealers, they have no obligation to participate in bond auctions and bid for paper. For example, a Dealer may have taken RPT's in relation to the weighted average price of an auction. In the case of a tap auction the Dealer can trade the same bond in the secondary market to hedge. However, there is a risk that the Dealer or Primary Dealer could use this activity to artificially drive up the price going into the auction, leading to an artificially high reference price for the RPT.

The use of discounts by Dealers in the context of an auction is a commercial practice that may carry behavioural risks. Dealers should have appropriate procedures in place to ensure that any discounts are offered in a manner that does not exacerbate conflicts of interest or create incentives for the Dealer to act in an improper manner which may be detrimental to Investors or Issuers.

IV Principles and Commentary

5. Conflicts of Interest Management

Good Practice Statement 1: Primary Dealers and Dealers should take appropriate measures to identify conflicts of interest in auctions which arise as a result of their respective roles and, once identified, such conflicts should be prevented or appropriately managed and mitigated.

Some of the tools that firms can implement in order to assist with the identification, prevention and management of conflicts of interest are as follows:

i) Primary Dealers may consider implementing segregation of client Fixed Price Order flow that is to be entered into the auction system from its trading desk. However, it is noted that in certain circumstances this may not be possible and conflicts of interest must be managed in other ways.

As Issuers determine the auction system, adopting segregation of client Fixed Price Order flow could be facilitated by Issuers adapting auction terminals / systems to facilitate the segregation of client orders from house activity.

ii) Dealers and Primary Dealers may consider implementing appropriate supervision of auction related activity.

iii) Dealers and Primary Dealers may consider implementing post-auction first line or second line reviews through testing, monitoring and/or surveillance of auction activity, including but not limited to, reviewing Investor client's bids, RPTs and secondary market trading activity in and around the time of the relevant auction.

Good Practice Statement 2: Primary Dealers should ensure their bidding strategies are never designed for the purpose of improperly influencing or manipulating auction levels or related statistics and that such strategies comply with their obligations under the relevant Primary Dealer Agreement.

Where a Primary Dealer's auction bidding is done as a principal, its bidding strategy should be designed to meet any obligations under the relevant Primary Dealer Agreement, manage the risk of Investor client's orders (RPTs and Fixed Price Orders), and manage the Primary Dealer's own inventory (including to meet expected demand from their Investor clients in the secondary market).

Good Practice Statement 3: Dealers and Primary Dealers should manage their hedging of auction orders and secondary market activity in such a way that it is never performed for the purpose of improperly influencing or manipulating auction levels or related statistics.

When a Dealer or Primary Dealer is hedging Investor client orders in the secondary market, such Dealer or Primary Dealer should have regard to the effect that its hedging around the auction might have on the auction outcome and should balance the objectives of its hedging strategy against the possibility of putting undue pressure on the auction results, recognising that some price pressure is to be expected as risk is passed, particularly for large transactions or transactions in less liquid markets.

In order to mitigate the risk of undue pressure, hedging of Investor client orders in the secondary market should generally be at a pace consistent with prevailing market conditions. Dealers and Primary Dealers should be mindful of how they would manage risk from Fixed Price Orders or RPTs where the size of the risk becomes so material that the Primary Dealer activity could be seen to alter the pricing dynamic of the auction and notify Investors beforehand.

Good Practice Statement 4: Dealers and Primary Dealers should make information available to their Investor client on how they participate in auctions, in particular explain the fact that hedging can take place before, during or after an auction and explain the Dealer's Investor client order handling procedures.

6. Investor Participants

Good Practice Statement 5: Investors should not participate in auctions for the purpose of improperly influencing the Auction results

Investors participation in auctions should be a true reflection of their demand and should not be carried out to influence the auction or give a false sense of demand.

7. Information Handling

Good Practice Statement 6: Primary Dealers and Dealers should not disclose information about individual Investor client orders within their firms except to those persons who have a valid reason for receiving such information or as required with the Issuer pursuant to the Primary Dealer Agreement.

For further guidance on information handling you should review the FMSB's Statement of Good Practice on Information and Confidentiality for the Fixed Income and Commodities Markets.

8. Policies, Procedures & Training

Good Practice Statement 7: Primary Dealers and Dealers should consider having policies, procedures and/or guidance that they deem to be appropriate in relation to their arrangements around auctions in light of this SGP.

Good Practice Statement 8: Primary Dealers and Dealers should consider having training that is reasonably designed to ensure that relevant personnel understand and act in accordance with the substance of this SGP or the requirements of the policies, procedures or other guidance adopted by Market Participants in light of this SGP.