ASIAN BOND MARKETS INITIATIVE BRIEF No. 9

PRINCIPLES AND PRACTICES OF DUE DILIGENCE IN BOND UNDERWRITING

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Introduction

The Asian Bond Markets Initiative (ABMI) Brief series aims to provide insights on professional bond markets, their development, and their necessary or desirable components to issuers, investors, market intermediaries, regulatory authorities and policymakers, academia, and other interested parties.[1]

The previous four ABMI Briefs have focused on an introduction to professional bond markets and explained the concept of professional investors and their categories, the fundamentals of disclosure in the professional bond market, as well as the significance of using English as a common language in these markets. As advised in ABMI Brief No. 3—*Fundamentals of Disclosure in the Bond Market*, this brief makes a case for due diligence as a common business practice, with a focus on the importance and best practices of due diligence in bond underwriting, detailing its principles, elements, basic requirements, and variations—including advanced practices in the international bond market.

Due diligence is an important aspect of ensuring market integrity, including fair price determination and accurate disclosure. In a professional market environment, in particular, the ability of a self-regulatory organization (SRO), such as a market association, to set practical and reliable due diligence practices is seen as crucial, allowing for the continuous development of best

HIGHLIGHTS

- Due diligence in bond underwriting is an investigation conducted by the bond underwriter(s) during the issuance process to confirm the completeness and accuracy of the information in disclosure documents. Regulators expect it to be conducted with reasonable care, including all necessary investigation and confirmation efforts.
- Due diligence enables the issuer, the underwriter(s), legal counsel, and other intermediaries to identify business, legal, or regulatory issues, or unique risk factors relating to the issuer or its business environment that may materially impact prospective investors' decision-making.
- Due diligence in bond underwriting is an important process for achieving fair market price formation and protecting investors and related parties, including reducing risks for the underwriter(s) and the issuer from investor lawsuits. It is considered a mandatory business practice for both public offerings and private placements aimed at professional investors.
- An iterative approach to due diligence is considered best practice and enables the underwriter(s) to decide if the bonds are worth underwriting.

[1] This ABMI Brief was compiled by Satoru Yamadera, advisor to the Economic Research and Development Impact Department of the Asian Development Bank (ADB), and Shigehito Inukai and Matthias Schmidt, ADB consultants, using materials prepared by the late Hirohiko Suzuki, ABMF international expert and member of the ABMF Working Group for Comparative Capital Market Law and Regulations, with valuable input and expertise from conversations and correspondence with Shuji Yanase, chairperson of the Capital Markets Association for Asia, formerly of Nagashima Ohno & Tsunematsu, and Tony Grundy of Mori Hamada & Matsumoto. The team would like to acknowledge the significant contributions to ABMF of Mr. Suzuki, who had been participating in bond underwriting and underwriting examinations in the Japanese, Eurobond, and international bond markets at major international investment banks for many years.

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practices, including those in line with international markets. A soon-to-be published ABMI Brief will detail the significance of market integrity and its inherent aspects.

From the perspective of emerging market regulators, it may seem challenging to leave part of their remit in the hands of the market participants they are meant to regulate, but—and this is true particularly for the professional bond market and also the bond market at large—as a market matures, it is desirable to move from a regulator's approval-based issuance process to market-based issuance procedures to encourage an active marketplace. The due diligence concept, carried out by market participants, serves as an essential safeguard for such active marketplaces.[2]

What is Due Diligence?

Traditionally, the term "due diligence" refers to requisite effort or the application of reasonable care. In a legal context, the term has come to mean "the degree of care or effort that a person of ordinary prudent conduct would be reasonably expected to exercise in the particular circumstances" or "the care that a reasonable person exercises to avoid harm to other persons or their property."[3]

Applied to financial markets, and from a practical perspective, due diligence is a process or collective effort by a party to obtain and analyze information before making a decision or conducting a transaction so that such a transaction is proven viable and the party is not held legally liable for any loss or damage.[4]

As a matter of best practice, due diligence is an iterative process, which is to say that initial information should be revalidated throughout the preparation for a business transaction in a structured manner, using agreed process steps or specific milestones to support the decision to proceed. (Recognizing the significance of this iteration, some of the information contained in this brief is—intentionally—presented more than once.)

ASEAN+3 Bond Market Forum

The ASEAN+3 Bond Market Forum (ABMF) was established in 2010 under the Asian Bond Markets Initiative by the ASEAN+3 Finance Ministers, with a mandate to support the development of regional local currency bond markets. Since then, ABMF has acted as a platform for dialogue among public and private sector stakeholders in regional bond markets and promoted the exchange and evaluation of ideas among finance ministries, securities regulators, securities exchanges, depositories, custodian banks, underwriters, and other market intermediary organizations. ABMF discussion outcomes have helped to address common issues and formulate policy recommendations.

The Asian Development Bank publishes the ASEAN+3 Bond Market Guide series, which was created and is updated by ABMF, for interested parties. The economy-level bond market guides serve as reference material to learn more about individual regional markets' development, help address misperceptions, and disseminate regional bond market information to a larger audience. ABMF has proposed, agreed on, and helped implement the ASEAN+3 Multi-Currency Bond Issuance Framework as one practical initiative toward harmonizing the professional bond markets in ASEAN+3 member economies.

As part of its efforts, ABMF created the Working Group for Comparative Capital Market Law and Regulations to research market foundations and practices. The working group will share observations and policy input with constituents and the public, particularly on the region's professional bond markets.

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[2] While the terms "bonds" and "bond underwriting" are used in this brief, the principles and practices reviewed should be seen as applying to the issuance of bonds, notes, and *sukuk* (Islamic bonds), as well as other instruments in the bond or capital market at large.

[3] Adapted from Thomson Reuters. Due Diligence–Legal Glossary: What is Due Diligence? https://legal.thomsonreuters.com/blog/due-diligence-in-legal-finance-business-and-other-sectors/; and LexisNexis. Due Diligence: What You Need to Know? https://www.lexisnexis.com/en-int/glossary/compliance/what-is-due-diligence.

[4] J. Chen. 2024. Due Diligence: Types and How to Perform. *Investopedia*. 31 August. https://www.investopedia.com/terms/d/duediligence.asp#:~:text=Due%20diligence%20is%20a%20process,most%20notably%20to%20business%20transactions.

A Context for Due Diligence

Due diligence as an overall concept has received significant attention from policymakers and regulatory authorities over the past decade, with top-level guidance being provided by international bodies and organizations. In addition, the application of environmental, social, and governance principles in the capital market, particularly the focus on sustainable finance, has instilled the need for due diligence in the market at large. At the same time, individual business sectors have been practicing or adopting industry-specific due diligence processes for many years.

G7 Leaders' Declaration 2015

In their Leaders' Declaration following the Group of Seven (G7) Summit in 2015, the group called for a stronger focus on due diligence in business conduct. While the focus at the time had been on due diligence, particularly on human rights and responsible supply chain management in the context of international trade, the inclusion of due diligence in the declaration became the impetus for work by other international bodies to promote the overall significance of due diligence in both general terms as well as for specific business sectors (see also the next section).[5]

OECD Due Diligence Guidance and Guidelines for Responsible Business Conduct

In February 2018, the Organisation for Economic Co-operation and Development (OECD) issued the *OECD Due Diligence Guidance for Responsible Business Conduct*. In this guidance, due diligence is explained as follows:

> Due diligence addresses actual adverse impacts or potential adverse impacts (risks) related to the following topics covered in the OECD Guidelines for Multinational Enterprises: human rights, including workers and industrial relations, environment, bribery and corruption, disclosure, and consumer interests (Responsible Business Conduct issues).[6]

According to its foreword, the guidance was (i) issued in response to recognition of the importance of business due diligence in the G7 Leaders' Declaration in 2015 (footnote 5); and (ii) created to help implement the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct (the Guidelines), originally issued in 2011 and updated in 2023. According to the OECD website, over three-quarters of OECD countries have adopted due diligence laws based on the OECD standards. The Guidelines should be understood as representing the recommendations of governments to international corporations, recognizing the vital role of multinational enterprises in developing the global economy, environment, and society. Participating governments expect that companies will voluntarily implement these recommendations on responsible business conduct (footnote 6).

Although the Guidelines are not legally binding, they still rank among the most important international documents on responsible business conduct for companies. Although the title references multinational enterprises, the Guidelines' principles and content are believed to benefit most companies, including small and medium-sized enterprises, in the ASEAN+3 region and globally.[7]

The 2018 guidance was meant to provide practical support to companies in implementing the Guidelines by explaining in plain language the due diligence recommendations and related provisions contained therein. Implementing these recommendations will help companies avoid and address adverse labor, human rights, environmental, bribery, disclosure, consumer, and corporate governance impacts associated with their operations, supply chains, and other business relationships. The annexes to the guidance provide additional explanations, tips, and illustrative examples of due diligence.

Implication for the Bond and Capital Market

While these recent initiatives are really focused on companies doing due diligence in relation to their own operations and the entities that they do business with, the OECD had already published a document on due diligence aimed at institutional investors in 2017.[8] In 2019, the OECD followed up on this guidance with a supplemental publication specifically for banks that sought to outline how banks and financial institutions

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[5] G7. 2015. *G7 Summit Leaders' Declaration*. https://www.mofa.go.jp/files/000084020.pdf.

[6] OECD. 2018. *OECD Due Diligence Guidance for Responsible Business Conduct*. https://www.oecd.org/en/publications/oecd-due-diligence-guidance-for-responsible-business-conduct_15f5f4b3-en.html.

[7] ASEAN+3 refers to the 10 members of the Association of Southeast Asian Nations (ASEAN) plus the People's Republic of China, Japan, and the Republic of Korea.

[8] OECD. 2017. *Responsible Business Conduct for Institutional Investors: Key Considerations for Due Diligence under the OECD Guidelines for Multinational Enterprises*. https://mneguidelines.oecd.org/RBC-for-Institutional-Investors.pdf.

can carry out due diligence processes in the context of corporate lending and securities underwriting transactions.[9]

However, underwriting due diligence as an integral part of bond market practice predates these initiatives by many decades (see the subsection on Due Diligence Standard for the Bond Market). It can be taken as fact that the scope of underwriting due diligence has been extended by the above initiatives, using the example of human rights due diligence. However, it would be wrong to treat these recent initiatives as the original source of due diligence law and practice for underwriters.

This ABMI Brief discusses due diligence in relation to bond underwriting in general. Having been identified as an essential part of the *OECD Due Diligence Guidance for Responsible Business Conduct*, due diligence specifically in relation to sustainable bonds (environmental, social, and governance bonds) or sustainable finance instruments may be covered in a future ABMI Brief.

What is Due Diligence in Bond Underwriting?

Due diligence in bond underwriting is an investigation usually conducted by the bond underwriter(s) as part of underwriting examinations during the issuance process, and before the offering or placement of bonds, to confirm the completeness and accuracy of the information in disclosure documents. Due diligence is an essential and indispensable concept for achieving fair-market price formation of the bonds; promoting sound investment decisions; and protecting investors, underwriters, issuers, and related parties.[10]

The due diligence effort covers the issuer's business operation, performance, and business environment. It is intended to perform a substantive and qualitative assessment on the information provided and also checks for any material omissions, misleading statements, or untrue statements in the issuer's representations. Due diligence may also cover compliance with international accounting standards, audit findings, and legal subjects such as important contracts or actual or potential lawsuits.

As evidenced by the adoption of due diligence policies, as well as a matter of best business practice, due diligence is mandatory for both public offerings and private placements aimed at professional investors. This includes disclosure documents such as a prospectus, an information memorandum, or similar key disclosure documents, and their preliminary versions. It also includes any other materials presented in the course of soliciting prospective investors, such as roadshow materials.

From an investor's perspective, or rather with the interest of investors in mind, adequate due diligence will ensure that data and statements provided by the issuer represent fact and can be a sound basis for an investment decision. While the information provided for public offerings and private placements may differ since it is aimed at different types of investors, the concept of disclosure and the significance of due diligence on such disclosure apply in principle to all types of investment. ABMI Brief No. 3—*Fundamentals of Disclosure in the Bond Market* offers more in-depth information on this subject.[11]

From the issuer's perspective and the viewpoint of the underwriter(s), the conduct of adequate due diligence reduces the risk of contravening relevant disclosure obligations in law, regulations, and listing rules, while limiting the potential of being sued by underwriters and/or investors in case of the—even inadvertent—use of inaccurate, incomplete, or misleading information when soliciting investors.

This practice also extends to law firms acting as legal counsel for the issuer, as well as to other agents. As an example, while it may not be common practice for law firms to give a legal opinion on disclosure, the leading law firms in the United Kingdom treat the inclusion of their name in the key disclosure document as creating potential liability for misstatements in that document.

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[9] OECD. 2019. *Due Diligence for Responsible Corporate Lending and Securities Underwriting: Key Considerations for Banks Implementing the OECD Guidelines for Multinational Enterprises.* https://mneguidelines.oecd.org/due-diligence-for-responsible-corporate-lending-and-securities-underwriting.pdf.

[10] "Related parties" in the context of the bond or capital market refers to all parties involved in the bond or securities issuance process, including the issuer, underwriters, selling agents, legal counsel, auditors, and other appointed agents. The term, related parties, carries significance in provisions and prohibitions in laws and regulations, particularly with regard to insider knowledge and other critical subjects that safeguard market integrity.

[11] ABMI Brief No. 3—*Fundamentals of Disclosure in the Bond Market* is available for download from *AsianBondsOnline* at https://asianbondsonline.adb.org/abmf/policy-briefs.html.

At the same time, law firms in the United States would typically issue a so-called "10b-5 letter," in which they take responsibility for the disclosure and due diligence. This marks due diligence as an important aspect of their involvement in a bond issuance.[12]

In effect, conducting appropriate due diligence enables the underwriters and related parties involved in the offering or placement of a bond to raise a defense to claims by investors under liability provisions in securities laws and regulations. In addition, repetitive due diligence enables underwriters to learn and decide if the bonds to be issued are worth underwriting and helps to determine the best structure, terms and conditions, disclosure, and marketing or placement strategy for the bonds.

Inexperienced issuers may not appreciate the protection afforded to them by including negative statements and risks in relation to their business; rather, issuers may view the disclosure document as a "sales document." It is the role of the underwriter(s) and the legal advisors to guide the issuer as part of the due diligence and disclosure process.

Due diligence enables the issuer, the underwriter(s), and their respective legal counsel to identify business, legal, regulatory issues, or unique risk factors relating to the issuer or its business environment that may materially impact the prospective investors' decision-making. It may also require extraordinary disclosure in the offering and placement documents. Besides, conducting appropriate due diligence, and the resultant high(er) quality of disclosure, may reinforce the reputations of issuers as well as underwriters. The reputation aspect is of particular importance in a competitive industry where the quality of disclosure might be one deciding factor for investor decisions.

Due diligence in bond underwriting (i) has several elements and consists of a number of steps and specific tasks as part of the underwriting examination and review by related parties, (ii) requires a particular sequence of these events, and (iii) employs certain specific technical terms—each of which is explained in detail in the next few sections.

Typically, the due diligence covered in this brief is only conducted for corporate bonds and is independent of the checks conducted by regulatory authorities relating to any necessary issuance, registration, or listing approvals for these bonds, as may be applicable in a given market. Market practice in some jurisdictions may not require due diligence on government bonds in the domestic bond market because sovereign issuers are typically defined as disclosure-exempt entities, and their bonds are considered a risk-free investment. However, investors may conduct limited due diligence on the proposed bond issue according to their mandate or investment strategy.

At the same time, information on a government's financial position and policies are typically readily available through statutory disclosures in the public domain. Governments often use roadshows or targeted events, during which dedicated disclosure is offered to specific potential investor groups or the market at large. International investors or underwriting syndicate members may also require a certain level of due diligence if a government issues bonds in a foreign market or in a foreign currency. By contrast, state-owned or government-linked companies—while often considered quasi-sovereign in nature—should be subject to a due diligence process if they do not include an express government guarantee. The due diligence principles and practices would likely be similar to those described elsewhere in this brief.

Due Diligence Standard for the Bond Market

Without prejudice to due diligence practices in other regions or specific bond markets, the standard for due diligence has been set by the Eurobond market, or the so-called "US 144a" market. In general, the practice in the United States has been somewhat more prevalent over the past 30 years—because it offers a convergence of practices for both debt and private equity securities. To what extent these practices may be referred to as the "global standard" is debatable; however, practices in these markets have been widely accepted across international bond markets, including for international bond issuances in the professional markets or market segments in financial centers in ASEAN+3.[13]

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[12] A 10b-5 letter is issued by a law firm pursuant to United States Securities and Exchange Commission Rule 10b-5 as a condition of the closing of a securities offering. Thomson Reuters. Practical Law–Glossary. Rule 10b-5 Disclosure Letter. https://uk.practicallaw.thomsonreuters.com/2-107-7182?transitionType=Default&contextData=(sc.Default)&firstPage=true.

[13] Rule 144a of the United States Securities and Exchange Commission sets conditions for the offering and sale of debt securities (and certain equity products) to professional investors via a private placement under an exempt regime. A. Hayes. 2024. Rule 144A. Definition, What It Allows, and Criticism. *Investopedia*. 19 June. https://www.investopedia.com/terms/r/rule144a.asp.

Due Diligence Elements

Many elements are required to make the due diligence process work. These include the right type and number of participants, in addition to the party conducting the underwriting examination; the choice of the most suitable approach to due diligence; and also particular aspects for which different persons and skill sets may be required.

Participants

Usually, the following parties participate in the due diligence process:

- issuer,
- issuer's legal counsel,
- the auditor for the issuer,
- lead manager or underwriter(s), and
- underwriter(s)' legal counsel.

The issuer's representation is from the finance and/or investor relations team (depending on the issuing company's size), overseen by the chief financial officer or other designated senior officer. The role of the issuer and its agents is to facilitate the necessary information required during the due diligence process. Specialist due diligence directors and managers represent the lead underwriter. Typically, the legal counsel of the lead underwriter or bookrunner—or of the underwriter if there is only one—would chair the due diligence meeting (or call), depending on a particular market's standard business practice.[14]

Due Diligence Approaches

There are two standard approaches to conducting due diligence in bond underwriting:

(i) **Required disclosure item due diligence**.
Due diligence is conducted to investigate only items required to be disclosed by law; regulations; and rules, including SRO rules.

(ii) **Quality and contents due diligence**.
Due diligence is conducted to investigate a much more comprehensive range of items than those required by law, regulations, and rules.

The applicable or most suitable approach for each instance of due diligence may be determined by circumstances as well as the market practice in a given economy. Yet, while both approaches are equally valid, each institution conducting due diligence may have its own specialized variations of these approaches, based on its underwriting expertise and market experiences. Institutions may feel that conducting required disclosure item due diligence might not be sufficient, and that quality and contents due diligence might be necessary as the standard approach. As mentioned previously, the quality of due diligence performed by an underwriter could be a key distinguishing factor for selection.

In the international bond market, highly reputable intermediaries conduct comprehensive due diligence based on their own (additional) in-house criteria, using quality and contents due diligence as a baseline. Such internal criteria could also include the premise that not every licensed or qualified service provider could participate in their deal but, instead, selection would be limited to only those intermediaries with a proven track record or who carried out due diligence and other tasks with a high level of precision. In consequence, parties having previously been involved in due diligence failures might find themselves no longer selected as deal participants. This approach is considered to have led to a higher overall quality of disclosure in the international bond market.

Common to both approaches is the expectation that underwriters conduct due diligence with what is typically referred to as "reasonable care." This expression may be based on definitions in law or regulations, or subject to interpretation by practitioners as well as the courts in any given economy. Often, market associations or SROs use their rules to set out certain minimum expectations for the level of care to be applied by industry participants. An example from Japan illustrates market expectations as well as the significance of setting applicable norms through interpretation by the courts **(Box 1)**.

[14] "Bookrunner" in investment banking is the term for the lead underwriting firm keeping the record of how much each underwriter or selling agent, or their underlying investors, have committed to subscribe. The bookrunner usually syndicates with other investment banks to offset its capital exposure and risk.

Box 1: A Case Study of Japan—Due Diligence Duty Confirmed by the Supreme Court

Japan's Financial Instruments and Exchange Act states that if a securities registration (disclosure) statement contains false or missing information on essential matters, the underwriter(s) is (are) liable to compensate the investor(s) who acquired the securities for damages resulting from the false or missing information. However, the underwriter(s) will not be liable for damages if they can prove grounds for exemption. As defined under different laws, as well as national and international standards, an accounting firm acting as auditor and issuing an audit certification stating that there are no false statements is liable for damages in the event such false statements are proven in the financial calculations—unless they can demonstrate that they arrived at the audit certification without malintent or negligence. In consequence, the underwriter is principally able to rely on the financial audit results.

If during the underwriting examination, the underwriter(s) come(s) across information that casts serious doubts on the reliability of the audit, they are required to investigate to confirm its reliability. If the underwriter(s) enter(s) into an underwriting agreement without conducting such investigation and confirmation, it will be deemed that the prerequisite for exemption from liability was not met. In this regard, if a false statement is in the financial calculation section, the underwriter(s) must prove they did not know about it. If a false statement is in a part other than the financial calculation section, the underwriter(s) must prove that they could not have known about it despite exercising reasonable care.

A groundbreaking Supreme Court ruling (No. 1961, handed down on 22 December 2020) established the norms for the implementation of due diligence in Japan and interpreted the significance of reasonable care. In a case brought by an investor on the basis of whistleblower information, the lead underwriter at the time was found responsible for not acting on multiple letters received during the underwriting examination about falsified financial statements and signs of window dressing that cast serious doubts on the audit's reliability and other warning signs; the underwriter had also chosen not to exercise their right to withdraw as underwriter of the initial public offering. The Supreme Court confirmed that an underwriter is required to investigate and confirm—as part of their due diligence—whether the audit lacks a basis for reliability, especially if corresponding information has come to light. The court did not recognize the exemption from liability for damages because the investigation of the underwriter did not exercise reasonable care under the circumstances and did not sufficiently prove the absence of serious doubts on the audit's reliability.

It was the first ruling in which Japan's Supreme Court determined the liability of an underwriter regarding window dressing by a to-be-listed company and demonstrated how a responsible lead underwriter should act: "continuously think and act from the investors' perspective." The same principle is seen as applying in both public offerings and professional investors markets.

Source: Supreme Court Third Petty Bench Judgment on December 22, 2020 regarding the Damage Compensation Claim Case of No. 1961 of 2018. A judgement summary in English is available at https://www.courts.go.jp/app/hanrei_en/detail?id=1810.

Targeted Subjects for the Due Diligence Process

Due diligence efforts are divided into a number of aspects, each having a particular focus—including checking different data, statements, or information—and likely involving different contact persons. At the same time, due diligence requires both accounting and legal knowledge and, hence, may need to be performed by different staff members of the underwriter.

In international markets, such as the Eurobond market, the due diligence process related to bond issuances mainly covers (i) the issuer, (ii) its management, (iii) the auditor for the issuer, and (iv) legal documents.

Consequently, the full due diligence can be broken down into issuer due diligence; management due diligence; auditor due diligence, including the "comfort letter"; legal due diligence; and guarantor due diligence (in the case of guaranteed bonds)—each of which is described below.

(i) **Issuer due diligence**. Underwriters, through materials submitted by the issuer, investigate its business operation, performance, and business environment to check any material omissions, misleading statements, or untrue expressions in the disclosure documents.

(ii) **Management due diligence**. Underwriters conduct a management interview with a senior officer of the issuer. The interview covers management policy and checks if statements in the disclosure documents are described correctly with no omission of material information, misleading statements, or untrue information.

(iii) **Auditor due diligence**. Underwriters conduct due diligence on the auditor to (a) investigate audit policy and material fact-finding by the auditors, (b) confirm no change in the audit opinion, and (c) obtain a comfort letter (see also the subsection on Main Due Diligence for a definition) from the auditors on financial information in the disclosure documents.

(iv) **Legal due diligence**. Where part of market practice, the underwriter's legal counsel conducts legal due diligence on the issuer to investigate material legal contracts—such as supply contracts, alliance contracts, and merger and acquisition-related contracts—to check if these contracts are unfavorable from an investor protection viewpoint. This due diligence subject may also cover a review of actual or potential lawsuits. Because of the sensitivity of this part of the due diligence, the underwriters' legal counsel mainly conducts legal due diligence without the underwriter's attendance. Instead, the underwriter's legal counsel reports on whether the legal due diligence findings are satisfactory.

(v) **Guarantor due diligence**. In the case of guaranteed bonds, underwriters also conduct due diligence on the guarantor to investigate aspects such as the guarantee policy and guarantee-related documents.

Due Diligence Process

The due diligence process consists of a number of steps, organized in a particular sequence and each step has its own specific tasks. While most of these steps are linear, best due diligence practice requires an iterative approach to the examination of all disclosure information. The due diligence process is subject to a defined timeline and timeframe, often with a preferred issue date or date range predetermined by market conditions. Individual steps are explained below, with each being put into the context of the overall timeline.

Main Due Diligence

The initial or main due diligence is carried out before filing, registration, or listing (profile listing) of offering (placement) documents. Here, the underwriter's legal counsel conducts the full scope of due diligence on the issuer, management, and representations by the auditor before filing, registration, listing or profile listing, or making preliminary disclosure documents available to prospective investors.

As part of the main due diligence, the underwriters seek to obtain a comfort letter **(Box 2)**, which is a document issued by a certified public accounting firm that acts as independent auditor of the issuer. In the comfort letter, the auditor declares or checks that figures and ratios stated in the prospectus, information memorandum, or other placement material for the bonds to be issued are correctly referred to or calculated from the audited financial statements, which follow the prevailing accounting standards, and there is no indication of missing, false, or misleading financial figures or ratios described in the disclosure materials:

(i) **Verification of financial information**. Auditors verify the issuer's financial information and ensure its accuracy. This allows the lead underwriter to provide reliable information to investors.

(ii) **Assessment of risk**. The letter evaluates the issuer's financial condition and business soundness and identifies potential risks. This allows the lead underwriter to manage relevant risks appropriately.

(iii) **Legal protection**. The letter also serves as a document to prove that the lead manager exercised "reasonable care" or "due care," reducing legal liability for missing, misleading, or false statements.

The format and content of comfort letters may vary from market to market, including in cases where the comfort letter practice does not exist; hence, market participants are encouraged to study these practices and implement them in their own markets.

Bring-Down Due Diligence

Bring-down due diligence is a series of follow-up due diligence efforts on the issuer and the information provided. Bring-down due diligence represents the iterative nature of due diligence as a matter of best practice. The primary purpose of bring-down due diligence is to check if there have been any material changes to disclosure information since the main due diligence and whether additional disclosure is required. Depending on the nature, complexity, or size of the proposed bond issuance, bring-down due diligence is conducted immediately before pricing (the second due diligence step) and before closing (the third due diligence step); the third step is intended to check on any material changes since the original bring-down due diligence was performed.

Box 2: Comfort Letter Formats and Practices

Practices and formats concerning comfort letters differ across economies and markets. For example, in the Eurobond market, a format introduced by the International Capital Market Association—as the quasi-self-regulatory organization for the Eurobond market—is commonly used, while the so-called SAS 72 (formally, SAS 72 auditor representation letter) or SAS 133 (formally, auditor involvement with exempt offering documents, in case of a private placement) formats are used in the United States. In Japan, based on Article 12, Paragraph 5 of the Rules Concerning Underwriting, Etc. of Securities of the Japan Securities Dealers Association, as the domestic self-regulatory organization, a letter from the auditor to the book runner is issued using a template prepared by the Japan Securities Dealers Association as the standard format for a comfort letter. At the same time, the SAS 72 and International Capital Market Association formats are also accepted, provided the issuer is a nonresident (i.e., in the case of a Samurai bond issuance).

Despite the different comfort letter formats mentioned above, a typical comfort letter includes the following subjects (with selected comments provided):

(i) statement of the accountant's independence from the issuer;
(ii) audit of the issuer's financials, compliant with laws concerning the audit;
(iii) statements regarding the accountant's review of quarterly or semiannual unaudited financial statements (quarterly or semiannual audit standards may be different from annual audit standards);
(iv) any changes in selected essential line items after the latest audit or financial statement date;[a] and
(v) comments on the results of confirmation procedures performed on financial information items in the disclosure materials to solicit prospective investors and reviewed by the underwriters.[b]

[a] Auditors can only provide limited comfort regarding the period between the last semiannual or quarterly statements and the agreed cut-off date. The auditor's procedures for this period are typically limited to asking the chief financial officer or any official of the issuer responsible for financial and accounting matters whether any changes occurred in line items, such as outstanding debt and outstanding equity.
[b] Underwriters identify the financial information items for the auditor to comment on, typically in the manner that auditors can provide comfort on information taken from, or based on, the issuer's financial statements or internal financial records, or accounting records that are subject to controls over financial reporting.
Source: Asian Bond Market Forum, based on material from Hirohiko Suzuki and other public domain information.

During bring-down due diligence, the issuer's auditor provides a bring-down (or a second comfort) letter before closing. With this, the auditor confirms that the previous comfort letter is still effective and that no event requiring amendment of audited financial figures has arisen since the last cut-off date. In this updated comfort letter(s), the auditor also reports on any line-item changes since the last audit date, financial statement dates, and the previous cut-off date.

Auditors typically have their own internal rules on the form and content of comfort letters in order to limit their own liability.

Underwriting Examination

At the core of due diligence in bond underwriting is the underwriting examination. Intermediaries that underwrite bonds not only perform underwriting tasks but also need to carry out underwriting examinations in-house. These tasks are—or should be—done by a separate unit at the underwriting firm. Usually, the underwriting examination section or responsible person(s) joins and conducts appropriate due diligence to form an underwriting examination opinion independent from the investment banking front office (e.g., the debt capital market department) or underwriting promotion business group at the firm to determine whether the underwriting is worthwhile. This also protects both the investors' and the firm's interests, as mentioned earlier.

Typical Underwriting Examination Prescriptions

Some markets in ASEAN+3 feature regulations or rules prescribing the need for underwriting examinations, typically set by a market association or similar SRO with rule-making capacity. This type of underwriting examination is not representative of the Eurobond market though.

An example for ASEAN+3 is shown below in the excerpt from the relevant rules of the Japanese Securities Dealers Association and stresses the independence of the underwriting examination function from other line departments of a firm:[15]

> Rules Concerning Underwriting, etc. of Securities, 1992
> Article 5: Ensuring the Independency [sic] of Underwriting Examination
>
> (1) Establishing an Underwriting Examination section;
>
> (2) Persons who conduct the Underwriting Examination in the Underwriting Examination section are not involved in the Underwriting Promotion Business or the Underwriting Business; and
>
> (3) Officers in charge of the Underwriting Examination section are not responsible for the Underwriting Promotion or Underwriting section.

In subsequent articles, the rules set out a number of criteria that an underwriter member of the Japanese Securities Dealers Association must fulfill, including prescriptions on the development of internal rules and the final decision-making process.

The due diligence process for bond issuances primarily emphasizes (i) any inquiries on the business' status and its prospects; (ii) the existence of and—potentially—the valuation of properties, if they have significance for the financial health of the issuer; (iii) the financial status of the issuer overall (e.g., as expressed in the balance sheet); and (iv) the issuer's operational results (e.g., as expressed in the profit-and-loss statement).

These inquiries are typically carried out through interviews with the principal executives of the issuer, such as the chief executive officer, the chief financial officer, or a designated officer, as well as the independent auditor of the company. Market practitioners state that interviews with the chief executive officer are often the most valuable tasks in becoming confident in the disclosure information. This is accompanied by a comprehensive review of corporate and financial records, including financial statements and the aforementioned legal due diligence of material contracts (i.e., those that have a significant bearing on the financial position and prospects of the issuer). At the same time, examinations also typically include a review of public domain sources and databases for information to corroborate direct findings. This culminates in the scrutiny of any draft and final disclosure documents to ensure accuracy of the stated information and to eliminate any misleading statements, untrue expressions, or material omissions. The primary points of these reviews are explained in detail in the next section.

Primary Points in the Underwriting Examination

While the underwriting examination may be conducted on a broad basis, possibly taking in many information sources, there are a number of primary points that will need to be covered under any circumstances. These (i) start from whether an issuer is principally eligible to issue bonds under law, regulations, and corporate mandate; (ii) center on the financial soundness of the business; (iii) assess the use of proceeds and the presence of general and specific risk factors; and (iv) cover other details that are specific to an issuer, its industry, or its circumstances. Some of the subjects reviewed during due diligence efforts may not be part of the offering or placement disclosure material but are necessary to substantiate disclosure items. Examples are given in the **Table**, based on the approach taken in Japan and as practiced in some ASEAN+3 markets, although subjects may also include other matters that an underwriter may deem necessary (see the subsection on Due Diligence Approaches).

An example in this context is the potential inclusion of profit forecasts. In some markets in ASEAN+3, and as stipulated by the London Stock Exchange, if a profit forecast has been published (e.g., if the issuer is a listed company), it is mandatory to disclose it in the prospectus (or corresponding key disclosure document) with a comfort letter from the auditors. At the same time, some emerging markets in the region may consider such forecasts as targets and therefore they do not carry any legal responsibility. Consequently, the question is whether to include a published profit forecast on the basis that it constitutes material information and whether the information has been prepared to a legal standard.

[15] Extract from the Japanese Securities Dealers Association Rules Concerning Underwriting, etc. of Securities, issued 13 May 1992 and remaining in force at the time of the publication of this brief. https://www.jsda.or.jp/en/rules-guidelines/E41.pdf.

Table: Primary Points in the Underwriting Examination

Focus Area	Primary Points
Eligibility of the issuer	- Is the issuer able to issue debt securities under prevailing laws or regulations? - Is the issuer able to issue debt securities, in the manner proposed, under existing corporate mandates? - Does the issuer fall under what in some markets may be termed an "antisocial force" or does it have any relationship with such antisocial force(s) or organized crime group(s)?
Soundness and change analysis of the financial condition and health of cash flow	- Soundness of the financial condition and health of cash flow - Analysis of changes in the financial condition, business performance, and cash flow, typically including • latest financial condition, • list of contingent liabilities, • current business performance, • critical subsequent events, • current orders, and • backlog of orders and sales - Outlook on business conditions - Expected balance sheet, expected cash flow table, and profit plan (even if not in formal disclosure)
Use of proceeds	- Purpose of the use of proceeds - Appropriateness of the purpose of use of proceeds - Proper disclosure of the purpose of use of proceeds - Appropriation of funds raised in the past
Basic consideration from the viewpoint of risk factors as the going concern	- Corporate group's unique business management policy - Extraordinary changes in the financial position, operating results, and cash flow - High dependence on specific business partners with whom continuity of transactions is unstable - High dependence on specific products, technologies, or similar with unclear potential - Damage relating to transactions based on particular trade practices - Long-term industrialization or commercialization of a new product or a new technology - Particular legal regulations - Important litigation cases - Material particulars relating to officers, employees, major shareholders, associated companies, and similar - Material business relationships between issuer and its officers or a shareholder that substantially holds voting rights majority - The going concern
Business risks—proper disclosure of the company's profile, business, management discussion, and analysis as the going concern	- Company profile (e.g., position and share in the industry, industry trend, business summary, change of business) - Accounting status (e.g., list of customers, suppliers, orders received and sales, list of affiliated companies) - Appropriateness of disclosed contents regarding company information, such as business risks, completeness of the scope of the disclosure, and adequacy of the representation of the disclosed information
Guarantor (in the case of guaranteed bonds)	Disclosure on the guarantor is subject to the underwriter's due diligence and comfort letter practices

Source: Based on materials prepared by Hirohiko Suzuki as ABMF international expert and member of the ABMF Working Group for Comparative Capital Market Law and Regulations.

Results of the Underwriting Examination

The underwriting examination will lead to, or substantially influence, a final decision on whether to underwrite the bonds. At the same time, the results of the underwriting examination may require revisions to the draft disclosure document. While the division conducting the underwriting review will function independently of the securities underwriter's business divisions, the results of the review may contain information that should be shared with the related parties conducting their own due diligence.

Conclusion

Due diligence plays a vital role in bond underwriting and the capital market at large. It is an essential process when intermediary institutions underwrite bonds (or other securities) and is a necessary means of protecting investors (as well as related parties) and ensuring the stability and integrity of the market. Several aspects in relation to market integrity will be explored in further detail in the upcoming ABMI Brief on Market Integrity and its Inherent Aspects.

Due diligence in bond underwriting is as much a philosophy as it is a set of tasks. Institutions need to embrace the concept of due diligence and apply the requisite measures in their organizations across the following aspects:

(i) **Risk assessment**. Through due diligence, various risks, including the credit risk of a bond, are assessed by thoroughly investigating the financial and management status of the issuer. This process helps investors minimize several risks.

(ii) **Legal compliance**. Legal due diligence ensures that the issuer is a legally sound company. This helps avoid or reduce future legal risks for investors, the underwriter, and the issuer.

(iii) **Investor protection**. Continuously conducting appropriate and high-quality due diligence helps provide investors with highly transparent information and ensures their credibility, which in turn helps sell-side participants gain their mid- to long-term trust.

(iv) **Market stability and integrity**. Conducting appropriate and high-quality due diligence can maintain the credibility, stability, and integrity of the entire market, helping to maintain its soundness in the long term.

In a business that is often sensitive to market conditions, institutions will need to find the right balance between commercial considerations and these due diligence aspects. This is particularly important in nascent markets as they add new market participants and encourage investor participation and increased bond issuance. It should, hence, be expected that due diligence processes and practices will continue to be further developed in regional bond markets. Once established, these due diligence aspects will significantly support market development and, at the same time, offer new international market participants a familiar reference framework to assess the market.

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