

TRINIDAD AND TOBAGO SECURITIES AND EXCHANGE COMMISSION



**GUIDELINES ON CAPITAL REQUIREMENTS FOR UNDERWRITERS
AND ISSUERS OF ASSET-BACKED SECURITIES REGISTERED UNDER
THE SECURITIES INDUSTRY ACT, 1995**

Issued in accordance with section 6(b) of the Securities Industry Act, 1995

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GUIDELINES ON CAPITAL REQUIREMENTS FOR UNDERWRITERS AND ISSUERS OF ASSET-BACKED SECURITIES REGISTERED UNDER THE SECURITIES INDUSTRY ACT, 1995

PART I – BACKGROUND AND PURPOSE

The adequacy of the capital held by underwriters registered under the Securities Industry Act, 1995 (the SIA) has become a matter of concern to the Commission. With a capital requirement of five million dollars, underwriters registered under the SIA are not subject to the same requirements as those registered under the Financial Institutions Act, 1993 (the FIA). The respective provisions of both Acts are set out hereunder.

Securities Industry Act and By-Laws

Section 59(3) of the SIA provides:

59(3) Every applicant for registration as an underwriter or investment adviser shall –

(d) either –

- (i) be a financial institution which is licensed under the Financial Institutions Act, 1993 to carry on the business of floating and underwriting securities; or
- (ii) meet the capital requirements as prescribed by the Commission

By-law 12 of the Securities Industry By-Laws, 1997 (the By-Laws) prescribes the capital requirements for underwriters.

12. (1) For the purposes of section 59(3)(d)(ii) of the Act, the capital requirement for an applicant for registration as –

- (a) an underwriter, shall be five million dollars; or
- (b) an investment adviser, shall be fifty thousand dollars.

Financial Institutions Act, 1993

Section 5(4) of the FIA provides:

(4) A person shall not carry on business of a financial nature without having a minimum paid up share capital of fifteen million dollars, or such larger amount as may be specified from time to time by Order of the Minister on the advice of the Central Bank.

Section 38(3) of the FIA states:

- (3) Regulations pertaining to prudential criteria may include but shall not be limited to –
 - (a) capital adequacy and solvency requirements and capital ratios;
 - (b) liquidity requirements and ratios.

Regulation 3 of the Financial Institutions (Prudential Criteria) Regulations, 1994 stipulates:

- 3. (1) Subject to subregulation (3), a licensee's qualifying capital shall not be less than eight per cent of its risk adjusted assets.

Risk adjusted assets are defined in regulation 8(1), which in turn refers to regulation 9(1) and Schedules I and II.

The Commission has reviewed the requirements of both Acts. Having regard to the potential risks to the market that can result from underwriting being undertaken by persons with inadequate capital, and the inequity in the financial market of Trinidad and Tobago resulting from the different capital requirements applied to persons conducting the business of underwriting as registrants under the SIA and licensees under the FIA, it has been decided to implement these Guidelines for the regulation of underwriters. The principal change is that persons registered to conduct the business of underwriting under the SIA are now required to demonstrate that they have capital of five percent (5%) of the value of the transaction. In the case of transactions that have been mandated but not yet fully subscribed, they must satisfy the Commission that they have capital amounting to five percent of the value of each proposed transaction.

The Commission also notes the failure by some applicants to clearly identify the characteristics of the new security being created, if it is indeed a new security, and the failure to accurately identify the true issuer of the security.

Finally, the Commission also notes with concern the issue of derivatives or asset-backed securities by persons purporting to be the "issuer" for the purposes of the transaction in cases where such persons cannot demonstrate the ability to acquire the security prior to creating the derivatives or asset-backed securities. Guidelines have therefore also been issued for the regulation of these activities.

PART II – GUIDELINES

CAPITAL REQUIREMENTS FOR UNDERWRITERS

1. Minimum paid-up capital of five per cent of the underwriter's net assets, with a minimum as prescribed by by-law 12

For the purposes of section 59(3)(d)(ii) of the Act, the capital requirement for an applicant for registration as an underwriter shall be five million dollars, as prescribed by by-law 12 of the Securities Industry By-Laws, 1997. Where such underwriter proposes to underwrite an issue of securities, it must demonstrate that it has net assets of five percent of the value of the transaction, subject to a minimum of five million dollars, as prescribed in by-law 12. Where the underwriter proposes to underwrite more than one transaction, it must demonstrate that it has net assets of five percent of the total value of those transactions.

The net assets are to be determined by the balance sheet for the most recently concluded month, and the statement of net assets must be certified by the Chief Executive Officer and two directors of the underwriter as being accurate.

Where net assets are less than five percent of the value of the transactions under consideration, the Commission may accept supplementary forms of capital such as letters of credit, guarantees and performance bonds from licensed financial institutions.

2. Retention of balance of an issue as an investment

Where an underwriter cannot syndicate an entire issue and keeps the balance on its books as an investment, such securities should be treated as acquired assets and reported on the balance sheet at fair value. If retained as an investment, it is presumed that the issuer has been paid and accordingly, the underwriter will indirectly have this counted as capital since it will be included in net assets.

3. Government issues not exempt

No issue that falls for consideration under the Guidelines will be exempt. Government issues carry underwriting risks as do other issues. The degree of such risk and the underwriters' exposure are more closely linked to the characteristics of the security being issued, rather than the status of the issuer. Given that both domestic and regional treasury debt issues have at times been under-subscribed, the Commission will apply the same capital requirements in respect of the underwriting of government securities.

4. Best efforts underwriting

Best efforts underwriting will not be treated differentially for the following reasons:

- (i) Companies can thwart the intention of the Guidelines through the use of best efforts contracts along with put options written to the issuer.
- (ii) Domestic market research indicates that most market actors have adequate capital to satisfy the capital requirements of the largest issues of securities if underwritten on a fully committed basis. The impact on underwriting capacity in the market is accordingly expected to be negligible.
- (iii) Domestic market research also indicates that most significant transactions in the market are not undertaken on a best efforts basis, given the competitive nature of the market and the requirements of better capitalized issuers.

5. Syndicated underwriting

The Commission will not consider the aggregate capital contributed by a number of underwriters participating in a syndication of an issue to be the basis for the determination of the capital requirement. Rather, the capital requirement must be satisfied in respect of each underwriter's proportionate commitment in the syndicate and not evaluated on a syndicate aggregate capital basis.

ASSET-BACKED SECURITIES

1. Identification of the relevant facts that establish that a new security is being created

An applicant for the registration of an asset-backed security or certificates of participation in an underlying security shall identify the relevant facts that establish that a new security is being created. A participation certificate represents an interest in a pool of funds or in other instruments. However, the nature of the interest varies. Some participation certificates represent an interest in new securities derived from an underlying security, while others represent the redistribution of the underlying security. Consequently, if it is claimed that participation certificates represent new securities, the differences in the characteristics of those securities vis-à-vis the underlying security must be identified, so as to enable the Commission to clearly distinguish between the two securities. By way of example, differences in the characteristics of the securities such as the tenor, rate of interest, other economic terms, and in particular, the rights that investors enjoy under the respective securities are material facts that ought to be highlighted.

The relevant disclosure requirements are contained in the attached **Schedule 1**.

2. The issuer of participation certificates or derivative securities must demonstrate to the satisfaction of the Commission that it owns or has the capacity to acquire at least eight percent of the underlying security

The issuer of the security must be clearly identified, and the documents submitted for registration of the security must be accurate and consistent with the stated position. The issuer of the participation certificates or derivative securities must demonstrate to the Commission that it either owns the underlying security or has the capacity to acquire a minimum of eight percent of the value of the issue.

The applicant must demonstrate that there are no outstanding liabilities attached to the underlying security that may be passed on to the certificate issuer. If there is any outstanding liability in relation to the underlying security, the amount of the liability should be stated, and the certificate issuer must demonstrate that it has the financial capacity to meet that liability. It should be noted that it is not sufficient for the issuer to show that it will be in a position to acquire the underlying security *after* it has created and/or issued the participation certificates or derivative securities.

The following conditions must be satisfied:

- (i) The issuer of the asset-backed security must establish ownership of the underlying security or the ability to acquire same.
- (ii) The ability to acquire the underlying security may be established by having the financial resources to acquire a percentage of the value of the issue. In this instance, the Commission requires the ability to demonstrate that the issuer has the capacity to acquire eight percent (8%) of the value of the issue.
- (iii) Cash collateral, letters of credit and net capital in excess of capital required to cover underwriting commitments may be relied upon to demonstrate the ability to acquire the underlying security.
- (iv) No derivative securities may be issued unless the related underlying asset is legally acquired to support all series of the distribution.
- (v) Reports on the distribution must be submitted to the Commission every six (6) months to allow for the review of the orderliness of the issue.

3. The issuer of the asset-backed securities is to be registered as a reporting issuer

The issuer of the asset-backed securities must be registered by the Commission as a reporting issuer. The purpose of this guideline is to ensure that the person who bears the risks associated with the issuance of the security is correctly identified and will

meet the reporting obligations. The issuer will be responsible for reporting on the performance of the security.

4. As a reporting issuer, the issuer is to report on the performance of the underlying security to the Commission and to the investors in the security

Once registered, the issuer of the asset-backed security is required to fulfill all the reporting obligations of a reporting issuer. These include the filing of its own annual reports, interim and comparative financial statements, and amended registration statements. These requirements are imposed by section 66(1) of the SIA and by-laws, 55, 56 and 54 of the By-Laws, respectively. Press releases indicating material changes must also be filed with the Commission and published in accordance with section 66(3) of the Act.

In addition to reporting on its **own** financial condition, as required for reporting issuers under the Securities Industry Act and By-Laws, reports should be filed on the financial condition of the issuer of the underlying security. This is particularly important where the issuer of the underlying security is not registered with the Commission. In such cases, the issuer of the asset-backed security must obtain and file the interim and comparative financial statements and annual report of the issuer of the underlying security, as well as any notices of material change.

In cases where the issuer of the underlying security is also registered with the Commission, the issuer of the asset-backed security may simply refer to the financial reports and annual report of that issuer.

5. Effective date

These Guidelines will come into force with effect from, 2006.

SCHEDULE 1

The following information must be provided in respect of a new asset-backed security, in order to establish that it is in fact a new security:

1. Details of the structure of the new security.
2. Cash flow modeling.
3. Differences in the characteristics of the securities such as the tenor, rate of interest and other economic terms
4. The rights that investors in the asset-backed security enjoy as compared with the rights that investors in the underlying security enjoy.