Guideline 5.2.4

COMMISSIONER OF BANKING
HONG KONG

香港
銀行業監理處

BANKING ORDINANCE

Underwriting of securities : Sections 81 and 87

A Guideline issued by the Commissioner of Banking under Section 7(3)

Introduction

This guideline explains the Office of the Commissioner of Banking's policy towards the underwriting and subunderwriting of securities by authorized institutions, in relation to sections 81 and 87 of the Banking Ordinance (the Ordinance).

Statutory position

2. Section 87 of the Ordinance has been amended to reduce the period of exemption for holdings of shares under an underwriting or subunderwriting contract from three months to seven working days "or such further period as the Commissioner of Banking (the Commissioner) approves in writing, and subject to such conditions as he may think proper to attach thereto". The main reasons for the change are to make the Commissioner aware of an exposure at an early stage, and to deter inexperienced players from taking on too large underwriting commitments at the outset.

3. Section 81 has been similarly amended in respect of any financial exposure acquired under an underwriting or subunderwriting contract. Any securities held in the same circumstances will not be included when calculating an institution's financial exposure to a particular counterparty. The seven day period of exemption runs from the time when the institution acquires the shares being underwritten. The effect of the amended section 81 is that no financial exposure arises under an underwriting or subunderwriting contract prior to the acquisition of any securities.

4. The Commissioner has discretion to extend the period of exemption from the limitations in sections 81 and 87, beyond seven working days. The manner in which he will do this is set out below.

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Policy

5. An underwriter which is left with shares at the end of the exemption period may find it difficult immediately to dispose of them in compliance with supervisory requirements.It is therefore important that the Commissioner is satisfied with the nature and scale of prospective underwriting transactions, before an institution enters into a commitment. This seeks to avoid the position where an institution is left with an imprudently large exposure at the end of seven working days, in circumstances where the Commissioner is not content to extend the period of exemption.

6. The following policy covers underwriting and subunderwriting commitments in respect of new securities, or further issues of existing securities, where the institution will only be called upon to purchase the securities if final investors fail to do so. It does not, however, cover "bought deals" where the institution acquires the securities from the outset as a principal for subsequent sale in the market or "block trades" in the secondary market. Holdings of securities in these latter circumstances will form part of a financial exposure covered by section 81 and a holding of share capital under section 87.

7. Any institution wishing to engage in underwriting activity is advised first to agree its plans with the Commissioner. In practice this will require the preparation of an underwriting policy by the institution, agreed by its board of directors (possibly as an adjunct to the lending policy). The policy will need to contain, inter alia, clear directions and limits on the type of transactions and securities which may be underwritten, the size of commitments which can be entered into and how excess risk is to be laid off with sub-underwriters. The Commissioner will also consider what underwriting the institution has undertaken in the past.

8. Some institutions will be able to demonstrate a greater experience in underwriting and more of a track record, than others. This, and the institution's own underwriting policy, will be two major factors affecting the maximum size of commitment which the Commissioner will agree with an institution that it can take on, according to the type of deal and securities involved.

9. The nature of risk arising from an underwriting transaction is mainly of a market rather than a credit nature. This means that any mechanism for setting an upper limit on underwriting exposures should reflect this characteristic.

10. In the United Kingdom, the Bank of England applies a credit conversion factor based on the Securities and Investments Board's/The Securities Association's own capital requirement, to the amount of securities being underwritten. The credit equivalent amount is then used as the basis for controlling the exposure according to whether the institution is perceived as an

"expert" or "non-expert" underwriter. To achieve some consistency of treatment between banks and securities intermediaries acting as underwriters, the Commissioner will adopt a similar approach based on the capital adequacy rules of the Securities and Futures Commission. However these are presently being revised. Allowance will be made for amounts which have been subunderwritten.

11. Until a more precise framework can be drawn up in this way, the Commissioner will agree in advance with individual institutions the maximum size and type of underwriting/subunderwriting transactions, measured on an aggregate basis per issuer, which they propose to undertake by referring where necessary to the Bank of England maxima. Prior consultation with the Commissioner will be necessary, however, where the insitution already has a financial exposure to the issuer concerned including in respect of other underwritings. The maximum allowable size of an underwriting transaction may need to be reduced to take account of this exposure.

12. Where an institution applies for consent of the Commissioner to hold shares beyond the seven day period of exemption, the Commissioner will give such consent for a period of not less than three months providing the underwriting commitment falls within a previously agreed limit as mentioned in paragraph 11 above.

13. Depending on the size of the limits agreed, the Commissioner may set a notification threshold below the upper limit, so that he is made aware of significant commitments being undertaken.

14. Where a proposed transaction would exceed a previously agreed limit, the prior approval of the Commissioner will be necessary. A speedy decision will be given in such cases.

Annex

DRAFT LETTER OF COMFORT FOR SECTION 81 (FROM BANK PARENT)

To : The Commissioner of Banking

Heading : [Name of Authorized Institution] ("the Company")
The Banking Ordinance, Cap. 155 ("the Ordinance")

In support of an application by the Company for exemption, under the provisions of section 81(6)(b) of the Ordinance, from the financial exposure restrictions contained in section 81(1) of the Ordinance, we state and confirm the following -

1. We are the legal and beneficial owners of ....% of the paid up share capital of the Company. It is our present intention to maintain that percentage holding in the Company. We undertake to inform you forthwith of any change in that intention and to consult you in advance of any likely decrease in that percentage holding;

2. It is in our interest that the Company continues to conduct its business as an Authorized Institution under, and in conformity with, the provisions of the Ordinance;

3. It is in our interest that the Company and its subsidiaries should meet their financial obligations at all times. It is our policy to provide the Company with such support and assistance as may be required to ensure that it maintain capital and liquidity levels to enable it at all times to meet its obligations in conformity with standards of prudence generally accepted for its field of business.

4. This letter of comfort was duly authorized by a resolution of our directors dated ...., copy of which is enclosed.

Yours, etc.