



CONSULTATION PAPER:
PROPOSAL TO REVISE
THE GUIDELINES
ON THE ISSUE OF
CALL WARRANTS

November 2002

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The Securities Commission invites comments on the proposals set out in this consultation paper. Comments may be sent by post, fax or e-mail to the following address:

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Comments should reach us by **27th November 2002**

Copies of the Consultation Paper are available for download from the SC's website:
www.sc.com.my

Note:

This Consultation Paper is issued solely for discussion and consultation purposes only.

PART ONE

1. Background

- 1.1 The purpose of this consultation paper is to set out the proposed revisions to the existing Guidelines on the Issue of Call Warrants (Guidelines). Due to requests from industry participants and development taking place in other jurisdictions, it is timely to liberalise the Guidelines to accommodate a wider variety of instruments and to further facilitate market development.
- 1.2 Regionally, Hong Kong and Singapore have both sought to further develop their derivative warrant markets. Exchanges in both markets have recently revised their frameworks to facilitate the listing of 'Structured Products', effective 1st July 2002. Internationally, the Financial Services Authority (FSA) in United Kingdom has decided to open the 'Securitised Derivatives' market to retail investors, which would enable a broad range of products to be eligible for listing, with the amended rules effective 1st August 2002.
- 1.3 In light of these developments and in an effort to further develop the call warrant market, the propose changes aim to make the Guidelines more relevant to current demands and bringing it in line with international best practices.

2. Objectives

- 2.1 The scope of the revision is to review:
- The criteria for stock eligibility;
 - The terms and conditions for the issuance of call warrants;
 - The trading and settlement terms of call warrants; and
 - The criteria for call warrants issuer.
- 2.2 In developing these proposals, the Securities Commission (SC) sought to create a regulatory framework that is more tailored to the specific requirements of derivative products, yet recognizing that in call warrants trading, there is substantial retail involvement. Thus, it hopes to achieve a balance between investor protection and facilitating access to listed markets

whilst maintaining the integrity and competitiveness of the Kuala Lumpur Stock Exchange (KLSE) for listed securities.

- 2.3 The SC would take into account the results of this consultation before publishing the Guidelines in its final form. Comments are to reach Product Development on or before the **27th November 2002**. The revised Guidelines are intended to be introduced following the conclusion of this consultation exercise.

PART TWO

3. Review the criteria for stock eligibility

- 3.1 The current Guidelines provide that to be eligible for warrant issuance, the underlying company must satisfy the following criteria:

- Average daily market capitalisation of at least RM2 billion for the past 3 months immediately preceding the date of issue;
- Average monthly turnover of at least 2 million shares for the 12 calendar months;
- Total number of registered shareholders must be at least 2000;
- Public float of at least 100 million; and
- An uninterrupted after tax profit record in the 5 financial years preceding the date of issue.

- 3.2 The above criteria have been argued as being too stringent compared to other markets. In Singapore, warrants can be issued on shares of a company whose market capitalisation must be at least S\$500 million (equivalent to RM1 billion) over the past 30 days or the paid up must be at least S\$200 million (equivalent to RM400 million). No further requirement on turnover volume or free float of the underlying is needed. In Hong Kong, companies need only meet the public float capitalisation criteria of HK\$4 billion (RM2 billion) to be eligible for single stock warrants issuance.

- 3.2 The purpose of the above criteria is to establish that a company is suitable for warrant issuance and will limit issuance to larger/blue chips companies, which are more likely to have a wider following among the investors. Some industry participants have expressed that the market capitalisation criteria should accommodate at least 40% of the top 100 KLSE stocks to be eligible for warrant issuance.

- 3.3 The implicit assumption behind the profitability of a company is to ensure that warrants are issued on 'good' companies. However, insisting on a 5 year profit record would exclude many 'good' companies who may experience temporary downturn in profits or a one time write offs, whilst their operating profits have been steady. Moreover, other exchanges such as in Hong Kong and Singapore do not have this requirement.
- 3.4 Taking into account the practices in other jurisdictions and to allow a healthy pool of companies to be eligible for warrant issuance without compromising market integrity, the following revisions are being considered;

Proposals:

- I. Reduce the market capitalization requirement to:***
 - (a) RM 1.5 billion; or***
 - (b) RM 1 billion;***
- II. Abolish the average monthly turnover of at least 2 million;***
- III. Abolish the five years profit record requirement; and***
- IV. Replace the requirements for 2000 registered shareholders and public float of 100 million with a requirement that the underlying shares must meet the KLSE's public shareholding's spread requirement.***

The SC invites comments on the above proposals, in particular the proposal to reduce the market capitalization requirement to RM 1.5 billion or RM 1 billion.

4. Review the Terms and Conditions of Warrant Issuance

4.1 The current Guidelines provide that the call warrants must:

- Have a maturity date of no earlier than one year and no later than two years from the date of issue;
- Have a minimum capitalization size of RM20 million;
- Be subjected to a maximum size which is no more than 10% of the share capital of the underlying company (aggregated with all other non-expired and unexercised call warrants of the same underlying shares); and
- Be in registered form and the registrar approved by the SC.

4.2 The minimum period of one year for warrant maturity has been argued as too long compared to other exchanges in the region. The exchange in Singapore does not impose a minimum limit whereas in Hong Kong, it has a minimum life of 6 months. Some industry participants have expressed interest in issuing a 6-months warrant, as that will be priced cheaper to longer dated warrants.

4.3 There have also been requests to lengthen the maturity of the warrant to 5 years. As call warrants are credit obligations of the issuers, too long a tenure for call warrants may be rather risky for the investor as over a longer period, there is more likely to be significant changes in the issuer's financial position. The exchange in Hong Kong has recently revised the maximum limit to 5 years and the Singapore Exchange has a maximum warrant life of no more than 3 years.

4.4 It has been argued that the current issuance limit of 10% of the share capital of the underlying company is too restrictive, citing that other markets are more liberal in this aspect. However, it is noted that many local big capitalisation stocks have a reasonable percentage of free shares but not too high, therefore it is difficult to justify a high issuance limit (such as 50% in Singapore). Furthermore, in Singapore and Hong Kong, issuers tend to issue no more than 10% of the share capital and would limit the warrant issue size to ensure that they were below 5-10 times average daily turnover. This is because issuers are concerned about the liquidity of the underlying for their delta hedging activities and that such activities should have limited effect on the underlying share price. In this respect the issuers' concern and that of the SC are aligned to some extent.

- 4.4 However for collateralised warrants, where the issue is fully backed by shares deposited with a custodian, such an issue would have minimum impact on the public float or share price of the underlying due to 'delta hedging'. In fact upon exercising the warrants, the public float of the underlying shares would be enhanced.

Proposals:

I. Expand the maturity of call warrants to:

- (a) No less than 6 months and no more than 5 years, or***
(b) Tenure must not exceed 5 years;

II. Increase the maximum size of issue, as follows:

The aggregate outstanding collateralised and non-collateralised call warrants issue at any one time including those already issued by other third party issuers on the same underlying shares that are still outstanding (i.e. not exercised and not expired) must not exceed 20% of the share capital of the company. However, the non-collateralised portion must not exceed 15% of the share capital of the company; and

III. Maintain the minimum capitalization size of RM 20 million.

The SC invites comments on the above proposals. In particular, the maturity of the warrant; should a minimum of 6 months be imposed or none.

5. Review the trading and settlement of call warrants

5.1 The current Guidelines provide that:

- Each call warrant must be in respect of one share (1:1);
- On initial listing, call warrants to be registered in the names of at least 100 holders;
- An initial placement to at least 10 licensed dealers and/or institutional investors;
- Rights of holders under call warrants must be exercisable American style;
- Settlement of the call warrants may be by way of delivery of the underlying shares or cash settlement at the option of the issuer;

- In the case of a cash settlement, the method of calculation is by taking the higher of the average closing prices of the underlying shares for the past 30 days and the closing price of the share on the market day immediately before the exercise date;
 - The terms of each issue of call warrants must contain appropriate anti-dilution provisions; and
 - The terms of each issue of call warrant must specify the rights of the warrant holders in the event of a take-over, merger, liquidation, dissolution, winding-up etc. of the underlying company.
- 5.2 Currently, call warrants can be offered at an entitlement ratio of 1:1. However, to introduce more flexibility in structuring the issue especially for basket warrant, it is proposed that other ratios such as 4:1 or 5:1 that will convert to whole number of a board lot of the underlying security be allowed. However, in the event that the warrant holder upon exercising might receive odd lot of the underlying shares, then this must be cash-settled. This is to ensure that the investors are not disadvantaged in any way.
- 5.3 Presently the exercise rights of holders must be American style. Exchanges in Singapore, Hong Kong and Australia have a variety of: American, European and Asian style warrants being launched. Moreover Asian and European style warrants are priced cheaper to American style warrants. To be in line with the regional exchanges in terms of variety of exercise styles and to continue to make available a range of exchange traded warrants to investors, it is proposed that other style of exercise be allowed.
- 5.4 The present Guidelines allow physical or cash settlement at the option of the issuer. In Hong Kong, the issuer's cash option has been prohibited since June 1998. This is to ensure that the warrant holders are not disadvantaged by such an option and to provide certainty as to the means of settlement. The exchange in Singapore has recently adopted the same settlement method as Hong Kong and prohibited the issuer's cash option. In reviewing the Guidelines, the SC views that such option to issuer should be removed, and issuers are required to specify whether a warrant will be cash or physically settled at the time of launch.
- 5.5 In the event of market disruption such as suspension of the underlying shares prior to settlement date or at settlement date, of 10 market days or more, the issuer will then have the option to cash-settle the warrants.

- 5.6 The current settlement method of taking the average of past 30 days closing prices has been argued as a 'deal killer'. Reason being that issuers would hold underlying shares as a hedge for non-collateralised warrants. When a warrant is exercised, the issuer will unwind that part of the hedge, which relates to the warrant, which is being exercised. For American style warrant which is exercisable prior to maturity, the issuer would need to pay the warrant holder the price based on the average of the past 30 days closing prices, which might be substantially different from the price he unwinds his hedge. The issuer will have no means of knowing when a warrant-holder intends to exercise the warrant until the exercise notice is received.
- 5.7 In other exchanges such as Hong Kong and Singapore, the cash settlement price is based on the average closing prices of the underlying security for 5 market days prior to and including the market day before the exercise date. However there are suggestions that the settlement price should be based on the volume weighted average price of the past 5 trading days and not on the average closing prices as additional safeguards against manipulation.
- 5.8 The placee requirement was introduced to ensure that there was sufficient interest in the call warrants justifying a listing on the exchange. Both the exchanges in Singapore and Hong Kong have no specifications on the number of dealers or institutional investors. There have been views expressed that the requirement for an initial placement to at least 10 licensed dealers and/or institutional investors is thought to be unnecessary.

Proposals:

- I. Expand the current conversion ratio to allow other ratios that would convert to one board lot of the underlying shares;**
- II. Allow other style of exercise, i.e. European style;**
- III. Settlement of warrants to be clearly specified at launch;**
- IV. In the case of call warrants that are cash settled, the settlement price is revised as follows:**

On Expiry Date

- (a) For both American and European styles, the settlement price is the volume weighted average of the closing prices of the underlying shares (subject to any adjustment to reflect any capitalisation issue, rights issue, distribution or the like) for 5 market days prior to and including the market day immediately before the relevant expiry date;**

Prior to Expiry Date

- (b) For American style warrants, the issuer could opt for the settlement price to be:**
 - (i) The volume weighted average of the closing prices of the underlying shares (subject to any adjustment to reflect any capitalisation issue, rights issue, distribution or the like) for 5 market days prior to and including the market day immediately before the exercise date; or**
 - (ii) The closing price of the underlying securities on the market day immediately before the relevant exercise date;**
- V. The terms and conditions must provide for automatic settlement on expiry (so that warrant-holders are not required to serve a notice of exercise) if the call warrants are “in-the-money” at expiry based on the settlement price;**
- VI. In the event of market disruption such as suspension of the underlying shares prior to settlement date or at settlement date, of 10 market days or more, the issuer will then have the option to cash-settle the warrants; and**

VII. Maintain the spread requirement of 100 warrant-holders; but abolish the requirement to place to at least 10 licensed dealers.

The SC invites comments on the above proposals.

6. Review the criteria for Issuer

6.1 The current Guidelines provide that:

- Any person may issue or sell fully-collateralised call warrants subject to:
 - (i) The terms of the security arrangements in respect of the underlying shares being approved by the Securities Commission;
 - (ii) A custodian or trustee approved by the Securities Commission being appointed to hold the shares the subject of the warrants and act in the interests of the warrant holders; and
- An issue of non-collateralised call warrants may be undertaken by:
 - (i) A body corporate approved by the Securities Commission;
 - (ii) A financial institution approved by Bank Negara; or
 - (iii) A body corporate guaranteed by an entity qualifying under paragraph (i) or (ii).

6.2 Call warrants can be divided into two categories: collateralised warrants and non-collateralised warrants. A collateralised warrant is one where the performance of the obligations of the issuer is secured by the deposit of securities or assets underlying the derivative warrant with an independent trustee, custodian or depository who holds the securities or assets for the benefit of the warrant holder.

6.2 Non-collateralised warrant is one where the performance of the issuer's obligation is not secured by the deposit of the underlying securities with an independent party. Instead the issuer will adopt hedging strategies to provide for its obligations under the derivative warrants. Therefore non-collateralised warrants constitute unsecured obligations of the issuer and the holders of such warrants are relying on the creditworthiness of the issuer.

6.3 Since the warrant market in Malaysia and regionally are characterised by a high level of retail participation, the SC takes the view that it is necessary for

the criteria relating to issuers, to be refined in line with the Capital Market Masterplan to provide some assurance, though by no means absolute, that the issuers will be able to honour the obligations under the call warrants they have issued.

- 6.4 The exchanges in London, Singapore and Australia require the issuers to meet a combination of net assets, regulatory requirement and credit rating requirement in order to be eligible to issue warrants. In Singapore, the issuer of a non-collateralised warrant must be a reputable financial institution with a minimum shareholder's funds of USD500 million (RM1.9 billion) and be supervised by a Monetary or Securities Authority.
- 6.5 In Hong Kong, a non-collateralised warrant issuer need to have a net asset value of not less than HKD2 billion (RM1 billion), a credit rating of the top three investment grades awarded by an agency recognized by the exchange and be regulated either by the Hong Kong Monetary Authority (HKMA) or the Securities and Futures Commission (SFC) or a government or state body backed by the full faith and credit of the government.
- 6.6 In light of the effort to strengthen the local stockbroking industry through broker consolidation, and the practice in other jurisdictions where a relatively high entry level has been imposed on issuers, there is a need to review the existing criteria for issuers to establish and promote a market that is competitive whilst maintaining high standards of integrity.

Proposal:

- I. Maintain current issuer requirements for fully-collateralised call warrants;***
- II. Maintain current issuer requirements for non-collateralised call warrants. However, in relation to the corporate body to be approved by the SC, the corporate body must:***
 - (a) Be a universal broker ; and***
 - (b) Have in place adequate and satisfactory risk management capability in relation a call warrant issue;***
- III. Exceptions to II (a) and II (b) would be considered based on the followings:***
 - (a) The issue of the call warrant is part of a corporate or debt restructuring scheme by the issuer that requires SC approval;***

- (b) The proposed risk management strategy and arrangement is acceptable to the SC, and may be addressed through the corporate or debt restructuring scheme itself;**
- (c) Approval, if granted, is for a specific call warrant issue only, and not on issuer basis; and**
- (d) Additional conditions may be imposed by the SC on the issue and/or the issuer.**

The SC welcomes views on the above proposed requirements relating to issuers.

PART THREE

7. Introduce Call Warrants on a Basket of Shares (Basket Warrants)

- 7.1 Basket warrants are essentially call options linked to the performance of a predetermined basket of underlying shares. That is, it gives one the right to buy a given quantity of the underlying basket of stocks from a third party issuer at a predetermined price.
- 7.2 This type of warrant will give investors an opportunity to access a sector of underlying shares e.g. banking sector or construction or index stocks, without having to buy a large basket of shares outright therefore reducing the capital outlay. Thus, an investor can buy a basket call warrant on the Kuala Lumpur Composite Index (KLCI) component stocks without having to amass the individuals stocks, in order to profit from the rise in the component shares.
- 7.3 Basket warrants are commonly issued European styled as the early exercise feature in American styled warrants would place a burden on issuer's hedging activities. However this is a commercial decision by the issuer.
- 7.4 In Singapore and Hong Kong, basket warrants are usually cash settled. The reference basket price of the basket warrant is normally arrived at by assigning weights to the closing prices of the underlying component stocks in the basket. If the basket warrant is 'in-the-money', then the difference (positive) between the reference basket price and exercise price at expiry will be paid to the holder.

- 7.5 Given the current market conditions, the SC is of the view that the requirements for a basket warrant issue should be the same as those in relation to a single stock call warrants issue. As such, there should not be any additional risks involved in buying basket warrants. Just like call warrants on a single stock, basket warrants may be collateralised or non-collateralised.

Proposal:

Call warrants on a basket of shares would be allowed subject to the issuer and issue complying with the same requirements for an issue of single stock call warrants.

The SC welcomes views on the above proposal in relation to basket warrants.