

# **EQUITY WARRANTS**

## **DISCUSSION PAPER**

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## EQUITY WARRANTS

### A DISCUSSION PAPER

#### **1 INTRODUCTION**

##### **1.1 Background to the review**

1.1.1 The Securities Commission has established a working group to review the market for equity warrants in New Zealand (the "Working Group"). The Working Group was set up for the purpose of considering whether an exemption policy should be established to better facilitate the development of the equity warrant market in New Zealand.

1.1.2 This review had its genesis in the development of equity warrant markets in overseas jurisdictions and in applications for exemption from certain provisions of the Securities Act 1978 (the "Act") and Securities Regulations 1983 (the "Regulations") made by various New Zealand and Australian based financial institutions and brokers.

1.1.3 The Commission recognises that there is currently much interest in establishing a market for equity warrants in New Zealand and that this market is potentially substantial.

1.1.4 The Commission is aware that there is some uncertainty as to how the Act applies to equity warrants. It has noted that it may be difficult and, sometimes, impossible for an issuer of equity warrants to comply with all of the requirements of the Act and Regulations.

1.1.5 Pursuant to section 5(5) of the Act the Commission may in its discretion exempt any person or class of persons from compliance with any provisions of Part II of the Act and any regulations made under the Act. In granting an exemption under section 5(5) of the Act the Commission may impose such terms and conditions as it thinks fit.

## 1.2 What are Equity Warrants?

1.2.1 In general terms, an equity warrant is a type of financial instrument that entitles the holder to:

- (a) require the issuer, at a specified future date or within a specified future period, to transfer to the holder equity securities of the type in respect of which the warrant is granted; or
- (b) receive, at a future date, a cash settlement from the issuer based on the value of the relevant equity securities at the applicable future date.

1.2.2 Equity warrants do not include warrants which provide for cash settlement with no option to require the issuer to transfer to the holder of a warrant the underlying securities.

1.2.3 Equity warrants are essentially long term transferable put or call options. A call option is a contract between two parties which gives one party the right, but not the obligation, to acquire the underlying instrument from the other party for a pre-determined price (known as the exercise price) on, or before, a pre-determined date (known as the expiry date), and for an agreed premium. A put option has equivalent characteristics except that it gives the holder the right to sell and obliges the counter party to buy the underlying instrument.

1.2.4 Equity warrants may be “naked”, “partially covered” or “fully covered”.

1.2.5 An equity warrant is “covered” where the issuer of the equity warrant (the “warrant-issuer”) holds the underlying securities required to meet that issuers obligations under the equity warrants or has placed the underlying securities into a trust or other similar arrangement, in order to meet its obligations should the holders of the warrant (the “warrant-holders”) decide to exercise the warrants. Performance by the warrant-issuer may be guaranteed by a third party, or the shares that are the subject of the equity warrant may be secured in favour of the warrant holders.

- 1.2.6 The warrants may be "fully covered" when the warrant-issuer has arranged for a number of underlying securities, which are sufficient to meet the exercise of all outstanding warrants, to be held by an independent trustee for the benefit of the warrant-holders. Alternatively, warrants may be "partially covered" in which case some, but not all, of the underlying securities are held by an independent trustee for the benefit of the warrant-holders. Alternatively the warrant-issuer holds 100% of the underlying securities but for its own benefit, sometimes with contractual restrictions limiting other activities, or borrowings, by the warrant-issuer
- 1.2.7 A "naked" equity warrant is one that is not backed by the underlying securities. The warrant-issuer or other party named in the warrant contracts that it will meet its obligations under the terms of the issue.
- 1.2.8 Equity warrants are usually tradable over a longer period of time than options and futures contracts. Warrants usually expire between 1-5 years from the date of the issue or grant although there are some warrants currently on the market which expire in 10 years.
- 1.3 Example of an issue of equity warrants currently on offer in Australia**
- 1.3.1 In January public offerings of Endowment Warrants were released to the Australian market. The warrants provide the holder with the right, but not the obligation, to acquire ordinary shares in "blue chip" Australian listed companies, on a date not later than ten years after original issue and, if certain dividend growth levels are achieved, for no further cost. The warrants are a long term leveraged investment instrument. There are no cash returns during their currency. The value of the warrant accrues internally and may be converted into cash by selling the warrant itself at any stage or by exercising the entitlement at expiry and selling the underlying share. The cost of the warrant, depending on the characteristics of the underlying share, ranges between 30% and 60% of the ordinary share price.

## 1.4 Benefits for Investors

- 1.4.1 The buyer of a warrant expects to benefit from an increase in value of the underlying share to a level higher than the exercise price of the warrant.
- 1.4.2 From an investor's point of view equity warrants offer hedging possibilities in competition with futures or option contracts and the opportunity for speculation. Holding equity warrants is a substitute (although not a perfect substitute) for ownership of the underlying securities but the holder will not receive all the benefits of ownership, for example, dividends, the right to vote, etc.
- 1.4.3 Equity warrants also offer an investor a type of gearing or leveraging since for a small capital outlay the investor can benefit in a potentially large gain. The down side risk is limited to the initial price of the equity warrant and not the price of the equity warrant.

## 1.5 Risks Inherent in warrant trading

- 1.5.1 Some of the risks facing investors in warrants are:
- (a) *Non-Performance of warrant-issuer:* The warrant-issuer may not be able to fulfill its obligations under the warrant. The obligations of a warrant-issuer under a warrant may be unsecured and may not be guaranteed by any other person. However an investor is limited in risk to the amount of funds invested to purchase the warrants. At no stage can an investor's risk exposure be greater than the initial investment sum. If the warrants are fully covered the warrant holder has greater protection provided the underlying securities are subject to a trust or other security arrangement designed to ensure that the terms of the warrant are met.
  - (b) *Secondary Market Liquidity:* There may be no assured market for the warrant.
  - (c) *Limited Life of a Warrant:* Unlike ordinary shares, a warrant has a limited life. During the life of the warrant, warrant holders need to regularly monitor their

investment to determine whether to exercise a warrant or sell their holding on the secondary market; and

- (d) *Extraordinary Events:* There may be certain circumstances in which a warrant-issuer may be entitled to cancel outstanding warrants, for example, delisting or suspension from trading of the underlying shares and takeovers. If a particular issue of warrants is cancelled under an extraordinary event the warrant-holder will not have any residual liability but may be left with no recourse to the warrant-issuer. However some issuers include an automatic variation clause when on the happening of specified events (eg takeovers, bonus issues, share splits) the property which constitutes the underlying parcel is automatically and immediately varied. Other issuers provide for an earlier exercise date on the happening of certain events

## 1.6 Scope of Review

1.6.1 There are a number of different circumstances in which equity warrants are issued. These include:

- (a) a listed entity issuing warrants in respect of its own equity securities. In these circumstances the issuer of the warrant and the issuer of the underlying security are identical. In this situation, the issuer should have fewer problems complying with the relevant provisions of the Act and Regulations. These types of warrants are often referred to overseas as “stock warrants” or “share warrants”;
- (b) a related company to the issuer of the underlying equity securities offers warrants in respect of the equity securities of that issuer whether issued or to be issued. Here, the issuer of the warrant may be assumed to be acting in concert with the issuer of the underlying equity and may have access to the type of information which is included in a registered prospectus concerning the issuer of the underlying securities; and
- (c) an issuer (often a financial institution) offers equity warrants giving holders the

right to acquire shares in a company which is unrelated to the issuer, at a stated price within a stated time limit. The company that issued the underlying equity securities may or may not be involved in the issue of the warrants and the issuer of the warrants may not have access to anything other than public information concerning the issuer of the underlying securities. Effectively, subject to arbitrage considerations, exercise of the warrant has no more effect on the issuer of the underlying security than a transaction in its shares on the secondary market.

- 1.6.2 This discussion paper is principally concerned with the particular difficulties of compliance which arise where equity warrants are to be issued by a person unrelated to the issuer of the underlying shares (as described in paragraph 1.5.1(c) above) and the issuer of the underlying securities is not otherwise involved. However if the Commission considers it appropriate to use its exemption power it will ensure comparability of regulation among the different circumstances in which equity warrants are issued.

## **2 THE REGULATION OF EQUITY WARRANTS IN NEW ZEALAND**

### **2.1 Classification of Equity Warrants under the Act**

- 2.1.1 As is the case with options and other forms of contingent interests there are some issues as to the extent equity warrants come within the definition of "equity security" for the purposes of the Act.
- 2.1.2 Many options or warrants will represent a *"right to or interest in a share"*, as those words are used in the definition of "equity security" in section 2(1) of the Act but the obligation matching that right will be an obligation of the warrant-issuer, not an obligation of the issuer of the underlying shares. Moreover some warrants may not be a right to a share but rather a right to require the issuer of the warrant to procure the transfer to the warrant-holder of the share underlying the warrant.
- 2.1.3 "Debt security" and "equity security" are separately defined terms in the Act. The other

relevant definition is the general definition of "security" namely, any *"interest or right to participate in any capital, assets, earnings, royalties, or other property of any person"* and include

(a) *Any interest in or right to be paid money that is, or is to be deposited with, lent to, or otherwise owing by, any person;*

- 2.1.4 As a general rule, at common law, there is no legal interest in the shares underlying an option until the contract for sale and purchase of the shares is concluded. The issue is whether an equity warrant creates *"an interest or right to participate in...property"*.
- 2.1.5 The answer to that question is uncertain, particularly where the issuer of the warrant and the issuer of the underlying securities are not related. In that case there will be no interest or right to participate in the property of the company issuing the underlying shares. However, it may generally be arguable that the holder has an interest or right to participate in the property of the issuer of the warrant.
- 2.1.6 When an equity warrant is "covered" arguably the warrant-holder is in a similar or even better position to a secured creditor and has at least a contingent interest in the property of the warrant-issuer.
- 2.1.7 More difficult is where the warrant-issuer does not hold the underlying securities, guarantee or give security for performance. Generally speaking purely contractual rights do not create an interest or right to participate in property at law. Whether these warrants are "securities" as defined may turn on whether the term "interest" in the definition of "security" includes a contingent interest in the future property of the warrant-issuer.
- 2.1.8 This issue, whether the term "interest" includes a contingent interest, is currently being addressed by the Commission as part of its review of the Act. The Commission considers the better view to be that the Act should apply on the basis that options and warrants for equity securities are themselves equity securities. It is the Commission's view that it should be explicitly stated that a contingent entitlement constitutes an "interest" for the purposes of the Act.



2.1.9 The Commission also observes that if equity warrants are not equity securities they may be participatory securities in that there may nevertheless be a right to participate in the property of the warrant-issuer.

2.1.10 The effect of the Act applying is that the warrant-issuer has to register a prospectus which contains the information specified in the First Schedule of the Regulations. The matters required to be disclosed are in respect of information about the warrant-issuer, the issuer of the underlying shares and the underlying shares. This may cause difficulties in that the warrant-issuer may not have access to information relating to the underlying shares and the issuer of those shares.

## 2.2 Classification of equity warrants as futures contracts

2.2.1 In addition, some forms of equity warrants seem to have similar characteristics to a futures contract. The term "futures contract" is defined in section 37 of the Securities Amendment Act 1988 (the "Amendment Act") as being:

*"Futures contract" means--*

- (a) *An agreement under which one party agrees to deliver to another party at a specified future time a specified commodity or a quantity of a specified commodity at a price which is fixed when the agreement is made but under which it is contemplated or understood that the obligations of the parties may be satisfied by means other than actual delivery:*
- (b) *An agreement under which each party has either--*
  - (i) *An obligation to pay a sum of money to the other or to credit the account of the other with payment of a sum of money; or*
  - (ii) *A right to receive payment, or a credit, of a sum of money from the other-- depending on whether at a future date the value or price of a specified commodity calculated in a manner specified by, or in accordance with, the agreement is greater or less than the value or price agreed upon by the parties when the agreement was made:*
- (c) *An agreement under which each party has either--*

- (i) *An obligation to pay a sum of money to the other or to credit the account of the other with payment of a sum of money; or*
- (ii) *A right to receive payments or a credit, of a sum of money from the other-- depending on whether at a future date the value or level of a specified index calculated in a manner specified by, or in accordance with, the agreement is greater or less than the value or level agreed upon by the parties when the agreement was made:*
- (d) *An option or right to assume, at a specified price or value, or within a specified period, or by a specified date, rights and obligations under an agreement of a kind described in a preceding paragraph:*
- (e) *An agreement, option or right which is declared by the Commission, in accordance with this section, to be an agreement, option or right to which this Part of this Act applies:*
- (f) *An agreement, option or right which is of a class of agreements, options or rights declared by the Commission, in accordance with this section, to be a class to which this Part of this Act applies:*

### *Commodity*

2.2.2 An essential element of a futures contract is that the contract must relate to a "commodity". "Commodity" is defined as "any type of goods; and includes foreign currency and a financial instrument". "Goods" are not defined in the Act. At common law goods are considered synonymous with chattels and except for in the estate context, where "goods and chattels" covers personal property of every kind excluding only real property, there has often been doubt expressed as to whether "goods" include choses in action, particularly shares and money. Many statutory definitions exclude choses in action.

2.2.3 It appears that the definition in s37(1) recognises the limited meaning of "goods" by expressly including foreign currency and financial instruments. "Financial instruments" is not defined in the Act. However the Financial Reporting Standard 31 Disclosure of Information about Financial Instruments includes a definition of "financial instruments" and equity warrants appears to be within this definition.

*Mutuality*

2.2.4 The wording of paras (b) and (c) of the “futures contract” definition requires there to be an agreement under which either party has either an obligation to pay or a right to receive a sum of money. As equity warrants give holders a simple option to purchase securities, the element of mutuality is not present as there will not be an obligation to pay a sum of money if the holder decides not to exercise the warrant. Paragraph (d) of the definition only includes options to assume rights and obligations under a contract which are call options.

*Section 37(7)*

2.2.5 Therefore it appears that equity warrants are unlikely to be "futures contracts" as defined in the Amendment Act. However section 37(7) enables the Commission to declare agreements or options which would otherwise fall outside the definition of “futures contracts” to be future contracts.

2.2.6 As equity warrants are functionally similar to future contracts one option would be for the Commission’s power in s37(7) to be used to bring equity warrants within the regulation regime of “futures contracts”. This depends on the significance placed on the differences between warrants and futures. The differences are that warrants contain a right, not an obligation, for the warrant-holder to require transfer of the shares, and, in most cases warrants require payment or satisfaction of the initial price of the warrant where futures do not.

2.2.7 The argument is stronger for naked warrants to be declared futures contracts in light of the uncertainty over whether there is an interest in property to bring the naked warrants within the definition of "securities".

2.2.8 If equity warrants were declared futures contracts section 38 of the Securities Amendment Act would prohibit persons dealing in equity warrants unless authorised by the Commission. Authorisations can be in relation to specific futures contracts or futures contracts generally. Conditions can be imposed on the authorisation.

2.2.9 It should be noted that an option on a futures contract is also a futures contract for the

purposes of the Amendment Act but the definition only encompasses options to assume a futures contract as otherwise defined in section 38 of the Amendment Act.

### *LEPO's*

2.2.10 A recent decision of the Full Federal Court of Appeal in Australia is relevant to our discussion on whether the Commission should regard equity warrants as securities or futures.

2.2.11 The Full Federal Court of Appeal in Australia in *Sydney Futures Exchange Limited v Australian Stock Exchange Limited & Australian Securities Commission (Intervener) (1995) 13 ACLC 369* held that low exercise price options (LEPO's) are securities and not futures contracts for the purposes of the Australian Corporations Law.

2.2.12 For LEPO's to be within the definition of "futures contract" in section 72(1) of the Corporations Law there had to be a "chapter 8 agreement" that is, an "eligible commodity agreement"(as defined in the Act). A LEPO was held not to be an eligible commodity agreement because:

- (a) there was no obligation to make or accept delivery; and
- (b) LEPO's were not within the definition of "commodity" as the judges considered they were not capable of delivery.

2.2.13 LEPO's were held to be within the definition of "security" in section 9 by virtue of being an "option contract".

2.2.14 The Corporations Law (Securities and Futures) Amendment Act 1995 inserted ss72A and 92A so that newly developed derivatives may now be treated as either securities and/or futures or be exempt from regulation as deemed by regulations.

## 2.3 **New Zealand Stock Exchange Listing Requirements**

2.3.1 In June 1991 the New Zealand Stock Exchange ("NZSE") adopted rules for the listing of equity warrants (Seventh Schedule of the NZSE Listing Requirements) for the purpose of enabling a secondary market in warrants to be established. This development

reflected the desire of a number of capital market participants to introduce warrants into New Zealand. These rules were not carried forward into the revised NZSE Listing Rules as they were not being used.

2.3.2 These rules covered more than just "equity warrants". They covered warrants over "financial instruments" which were defined as including debt and equity securities.

2.3.3 Pursuant to the Seventh Schedule of the NZSE Listing Requirements issuers who were approved by the NZSE could apply to the NZSE to list warrants on the NZSE provided that the terms of issue were set out in a memorandum of offer containing, among other things, all the information which is reasonably required to describe the warrant, its relationship to the underlying financial instrument and the capacity of the warrant-issuer to fulfill its obligations under the warrant.

### **3 THE REGULATION OF EQUITY WARRANTS IN AUSTRALIA**

#### **3.1 The Requirements of Australian Law**

3.1.1 In Australia, specific rules have been adopted to allow the issue of warrants. Trading of warrants in Australia is governed by section 8 of the Business Rules of the Australian Stock Exchange (the "Business Rules").

3.1.2 The ASC has not confirmed whether warrants are "securities" for the purposes of Part 7.12 of the Corporations Law. The ASC has preferred to approach this matter on the basis that it is willing to grant relief from the prospectus and share hawking provisions of the Corporations Law on the basis that there is an alternative regulatory regime (ie ASX Business Rules) which addresses the disclosure issues.

#### **3.2 Admission to Trading Status**

3.2.1 Admission to Trading Status (authorisation by the ASX for a warrant to be traded on a market of the ASX) is granted for a specific Warrant Series after the warrant-issuer has completed a form of application as prescribed in the Business Rules and lodged the

completed form of application with the ASX who has no objection to admission.

3.2.2 Listed below are some of the typical types of warrants issued and traded on the ASX Warrant Market.

- (a) *Equity Warrants* - warrants over listed equity securities where the issuer is not required to hold the underlying shares;
- (b) *Index Warrants* - warrants issued over an index such as the share price index;
- (c) *Fully Covered Equity Warrants* - deliverable equity warrants in respect of which the warrant-issuer has arranged for a number of underlying securities sufficient to meet the exercise of all outstanding warrants to be subject to a trust or other similar arrangement; and
- (d) *Basket Warrants* - equity warrants over the shares of more than one company.

### 3.3 Authorised Issuers of Warrants

3.3.1 Admission to Trading Status will only be granted to warrants issued by a warrant-issuer approved by the ASX.

3.3.2 The categories of Approved warrant-issuers are as follows:

- (a) an institution which is subject to the Banking Act 1959;
- (b) a government;
- (c) an institution which:
  - (i) holds a securities dealers licence or a licence in another jurisdiction which makes it subject to adequate supervision of capital standards;
  - (ii) has a long term debt rating of investment grade or its equivalent by a rating agency acceptable to the Exchange;
  - (iii) has net tangible assets which in the opinion of the Exchange are sufficient to support the proposed issue; and
  - (iv) is acceptable the Exchange;
- (d) an institution with a guarantor which comes within categories (a) to (c) which has provided an unconditional and irrevocable guarantee in favour of the

warrant-holder;

- (e) an institution which proposes to issue a series of fully covered equity warrants and is acceptable to the Exchange; or
- (f) any other warrant-issuer not objected to by the Exchange and not objected to by the Commission whose decision shall be final.

### 3.4 Section 8 of the Business Rules

3.4.1 Under Section 8 of the Business Rules a warrant-issuer is required, for each warrant issue, to prepare the terms of issue in an offering circular. The terms of issue set out the contractual obligations between the warrant-issuer and the warrant-holder. The offering circular explains the key features of the warrant issue and discloses the risks associated with dealing in the warrant.

3.4.2 Rule 8.7 of the Business Rules sets out the minimum requirements as to the content of offering circulars. Rule 8.7.5 states the general rule, which is that the offering circular must contain:

*"... all such information as investors and their professional advisors would reasonably require and reasonably expect to find in the Offering Circular for the purpose of making an informed assessment of :*

- (a) the capacity of the warrant-issuer to fulfill the obligations specified in the Terms of Issue; and*
- (b) risks, rights, and obligations associated with the warrant."*

3.4.3 The offering circular is not a registered prospectus under the Australian Corporations Law. However, copies of the offering circular and associated documentation must be lodged with the Australian Stock Exchange.

3.4.4 Of particular interest to Members of the Working Group are the provisions relating to fully covered equity warrants. These are warrants which must be subject to a "cover arrangement". The term cover arrangement is defined in the Business Rules as:

- "(a) a trust, the trustee of which is either an authorised Trustee Corporation (as that term is defined in the Corporations Law) or which meets the criteria for approval as a trustee for the purposes of Division 4 of Part 7.12 of the Corporations Law; or*
- (b) a trust, custodial, or other similar arrangement not objected to by the exchange and not objected to by the Commission,*

*to which the underlying financial instrument is subject and the terms of which preclude the warrant-issuer or other person from exercising control over the transfer or disposal of the underlying financial instrument other than;*

- (c) for the purpose of complying with the warrant-issuer's obligations in respect of the warrant;*
- (d) upon fulfilment of the warrant-issuer's obligations in respect of the warrant, for any purpose which the warrant-issuer directs; or*
- (e) for the purpose of complying with a direction of a Court."*

3.4.5 Section 8 of the Business Rules requires a warrant-issuer to ensure that the underlying shares held in the cover arrangement are dealt with only in accordance with the cover arrangement, an audit of compliance with the cover arrangement is undertaken annually and the audit report is lodged, together with the warrant-issuer's annual report, with the ASX.

3.4.6 Warrant-issuers must advise the market of any developments that may affect an investor's assessment of the risks involved in dealing with that institution by lodging a supplementary Offering Circular with the ASX.

3.4.7 Before any transaction in warrants can be effected on the ASX the client is required to sign a form stating, among other things, that they have seen the ASX's explanatory booklet relating to warrants. This booklet describes the risks involved in trading in warrants and the obligations of issuers under the Business Rules.



## **4 THE REGULATION OF EQUITY WARRANTS IN THE UK**

### **4.1 UK Legislation**

- 4.1.1 Part IV of the Financial Services Act (“FSA”) provides the statutory framework for the requirements for listing securities in the UK. However warrants fall outside the scope of Part IV of the FSA.
- 4.1.2 The London Stock Exchange has, however, been prepared to list such warrants under the residual power in section 142(9) of the Act which permits the Council of The Stock Exchange to admit investments, to which Part IV does not apply, to the Official List.
- 4.1.3 Part III of the Companies Act, which regulated prospectus offerings of shares or debentures, has recently been replaced by the introduction of the Public Offer of Securities Regulations 1995, (“POS Regulations) a new prospectus regime for offerings of securities which are not to be admitted to the Official List of the London Stock Exchange.

### **4.2 POS Regulations**

- 4.2.1 Part II of the POS Regulations extends the prospectus requirements, for the first time, to warrants conferring a right to acquire existing shares or bonds. Such securities fall within the scope of Part II of the POS Regulations but outside the scope of Part IV of the FSA. Previously warrants were not subject to the prospectus requirements of the Companies Act and if an application was made for a stock exchange listing it was only necessary to publish an equivalent offering document.

### **4.3 Form and content requirements**

- 4.3.1 The POS Regulations set out detailed form and contents requirements for prospectuses (regulation 8 and Schedule 1). The information must be presented in “as easily analysable and comprehensible a form as possible”. The detailed form and content rules are coupled with a general duty of disclosure. The prospectus must contain, in addition

to the information specifically required, all such information as investors would reasonably expect to find there for the purposes of making an informed assessment of the issuer and the rights attaching to the securities.

4.3.2 The specific information required for prospectuses includes:

- (a) details of the persons responsible for the prospectus, plus a responsibility statement by the directors of the issuer;
- (b) a description of the securities offered;
- (c) details of the purpose of the issue, the expected net proceeds, expenses and commissions and the names of the underwriters;
- (d) information about the issuer, its capital, business activities and management;
- (e) three years' accounts in the form of statutory audited accounts or an accountants' report;
- (f) interim accounts where any such accounts have been published since the last financial year end or where more than nine months has elapsed since the end of the last financial year; and
- (g) a review of the significant recent trends and a statement as to the prospects of the issuer for at least the current financial year.

4.3.3 The information must be given both with respect to the warrant-issuer and with respect to the issuer of the underlying securities into which the warrants are exercisable.

4.3.4 If the securities are guaranteed, the information must also be given with respect to the guarantor of the securities as well as the issuer.

#### 4.4 **The London Stock Exchange Listing Rules**

4.4.1 As the warrants are not within Part IV of the FSA specific rules have been adopted to allow the issue of warrants.

4.4.2 Warrants linked to equity securities of companies other than the warrant-issuers may be admitted to listing provided that those securities are listed on a stock exchange or traded

on another regulated and regularly operating open market.

4.4.3 The warrants must have a maturity of not more than five years.

#### 4.5 “Naked” Equity Warrants

4.5.1 An issuer seeking to list “naked” equity warrants must satisfy one of the following conditions for listing:

- (a) it must be regulated by the Securities and Investments Board, or by the Securities and Futures Authority Limited or be included on the list maintained by the Bank of England pursuant to section 43 of the FSA, provided that such activity falls within the approved scope of the issuer’s business;
- (b) it must be authorised under the Banking Act 1987;
- (c) if incorporated outside the United Kingdom, it must be regulated by an overseas securities or futures regulator which has a lead regulation agreement for financial supervision with the Securities and Investments Board, the Securities and Futures Authority Limited or the Bank of England;
- (d) it must be a State; or
- (e) the obligations created by the issuer must be unconditionally and irrevocably guaranteed by or benefit from an equivalent arrangement provided by an entity which satisfies one of the above conditions.

4.5.2 Issuers unable to satisfy any of the conditions stated in paragraph 4.5.1. must consult the Exchange and obtain specific approval. The Exchange may require such an issuer to provide a clear explanation of its proposed hedging strategy and include the explanation in the prospectus. In addition any such issuer or guarantor must have:

- (a) net assets of at least £50 million; or
- (b) an investment grade rating of its equity or unsecured debt by an appropriate agency.

#### **4.6 “Covered” Equity Warrants**

- 4.6.1 The issuer will not have to satisfy any of the conditions in paragraph 4.5 if the Exchange is satisfied that arrangements have been made for the underlying assets to be held by a trustee, for the benefit of the warrant-holder, to meet the exercise of all outstanding warrants. The trustee must have no interest in or relationship with the issuer which might conflict with its position of trustee.

### **5 THE REGULATION OF EQUITY WARRANTS IN HONG KONG**

#### **5.1 Hong Kong Legislation**

- 5.1.1 The offering of securities in Hong Kong is regulated by three pieces of legislation: the Companies Ordinance, the Protection of Investors Ordinance, and the Securities Ordinance.
- 5.1.2 The Securities Ordinance is relevant primarily in relation to the licensing of companies, firms and individuals involved in the offering of securities in Hong Kong. In addition where an application is made for the securities to be admitted to listing the listing rules must be complied with. The listing rules are dealt with separately in the following section.
- 5.1.3 The Companies Ordinance is primarily concerned with the establishment and operation of companies incorporated in Hong Kong and contains provisions regarding the distribution of prospectuses which offer any shares or debentures of a company to the public for subscription or purchase for cash or other consideration.
- 5.1.4 The Protection of Investors Ordinance is wider in scope than the Companies Ordinance in that it applies to offerings of securities generally. “Securities” is defined widely and includes warrants.

## **5.2 Exchange Listing Rules**

- 5.2.1 The Rules Governing the Listing of Securities on the Stock Exchange issued by the HKSE (the “Listing Rules”) set out the requirements which have to be met before securities may be listed and the continuing obligations with which a listed issuer must comply.
- 5.2.2 The present rules governing the listing of derivative warrants on the Stock Exchange of Hong Kong Limited are mainly set out, together with the provisions dealing with the listing of options, warrants and similar rights, in Chapter 15 of the Rules Governing the Listing of Securities on the Exchange.
- 5.2.3 The Exchange believes that the requirements for the listing of derivative warrants should be brought together in one chapter and is presently undertaking a review with the intention of creating a new chapter (Chapter 15A) devoted solely to the listing of derivative warrants.
- 5.2.4 As part of its review the Exchange wishes to ensure that such investors are adequately informed in relation to a particular derivative warrant and, in particular, of the ability of an issuer to perform its obligations. The Exchange is, therefore, looking to issuers to increase transparency by requiring issuers to make certain additional disclosures and to comply with certain additional continuing obligations whilst their derivative warrants are listed on the Exchange.

## **5.3 Existing requirements and the Exchange’s proposals**

### *“Covered warrants”*

- 5.3.1 The Derivative Warrant Rules divide derivative warrants into two categories; those which are “covered” and those which are “non-collateralised”.
- 5.3.2 To bring warrants within the “covered” warrants categories the Exchange requires the issuer to:

- (1) grant a charge over such securities or assets in favour of an independent trustee, custodian or depositary on behalf of the warrant-holders to secure the issuer's obligations to deliver such securities upon valid exercise of the warrants; deposit such securities with the trustee, custodian or depositary in order to secure performance by the issuer of such obligations and authorise the trustee, custodian or depositary to deliver the underlying securities or assets to the warrant-holders upon valid exercise of the warrants in the event that the issuer is unable to discharge its obligations under the derivative warrants; and
- (2) provide a warranty to the trustee, custodian or depositary for the benefit of the warrant-holders to the effect that the underlying securities or assets were unencumbered when they were deposited with the trustee, custodian or depositary, that the securities or assets are being held by the trustee, custodian or depositary for the benefit of the warrant-holders and the issuer will be to convey good title in the underlying securities or assets to the warrant holders free from all claims, charges, encumbrances, liens, equities and third party rights whatsoever, on valid exercise of the warrants.

5.3.3 The Exchange will normally require the trustee, custodian or depositary to be:

- (a) a bank licensed under section 16 of the Banking Ordinance;
- (b) a trust company which is a subsidiary of such a bank;
- (c) a trust company registered under Part VIII of the Trustee Ordinance; or
- (d) a banking institution or trust company incorporated outside Hong Kong which is acceptable to the Exchange.

#### *Suitability of Issuer*

5.3.4 To issue a covered warrant an issuer must satisfy the Exchange that they are suitable for listing. Suitability is determined by, amongst other things, the issuer's previous experience in handling issues of this nature.

5.3.5 An issuer of non-collateralised warrants must, in addition to satisfying the Exchange that it has the necessary previous experience, satisfy the Exchange that it is creditworthy by

showing that it is of “suitable financial standing”. “Suitable financial standing is normally satisfied by an issuer showing that it is subject to the regulation or supervision of a regulatory authority acceptable to the Exchange.

5.3.6 When an issuer of non-collateralised warrants is not regulated, it must satisfy the Exchange that it has net assets of at least HK\$1 billion; if it has obtained a credit rating from a credit rating agency recognised by the Exchange, that it has as a minimum an investment grade credit rating in respect of its equity or unsecured debt; and if requested by the Exchange provide the Exchange with a description of its proposed hedging strategies.

5.3.7 The Exchange proposes to introduce an additional requirement that a regulated issuer must have, as a minimum, a net asset value of HK\$1 billion and for an unregulated issuer to have, as a minimum, a net asset value of HK\$2 billion.

5.3.8 The issue of derivative warrants is restricted to the shares of “blue chip” companies.

#### **5.4 Listing Document**

5.4.1 An issue of equity warrants is required by the Listing Rules to be supported by a listing document. A listing document is defined as a prospectus, a circular or equivalent document issued or proposed to be issued in connection with an application for listing.

5.4.2 Chapter 11 sets out the Exchange’s requirements for the contents of listing documents relating to equity securities. Chapter 15 sets out additional information required in respect of derivative warrants.

5.4.3 The listing documents required must contain the following

- (1) the published audited consolidated financial statements of the warrant-issuer and the auditors’ report thereon, for the last two financial years preceding the issue of the listing document together with the information set out below:
  - (a) the total amount of any debt securities issued and outstanding;

- (b) the total amount of all other borrowing or indebtedness in the nature of borrowing distinguishing between guaranteed, unguaranteed, secured and unsecured borrowing and debt;
  - (c) all mortgages and charges; and
  - (d) the total amount of any contingent liabilities or guarantees.
- (2) the published audited consolidated financial statements and the auditors' report thereon, for the last two financial years in respect of each company whose shares the warrants relate to; and
- (3) full details of the underlying shares to which the derivative warrants relate including the following information:
- (a) a description of the principal activities of the relevant companies and their subsidiaries;
  - (b) details of their authorised and issued share capital;
  - (c) details of the directors' and substantial shareholders interests;
  - (d) market statistics covering at least the share price at the latest most practicable date, the market capitalisation, the historic price earnings multiple and dividend yield and a brief trading history of the shares over the two years immediately preceding the issue of the listing document;
  - (e) a statement as to the tax implications for Hong Kong investors who wish to invest in the derivative warrants; and
  - (f) any other information concerning the relevant companies which has been published generally and which is necessary to enable an investor to make an informed assessment of the value of the derivative warrant
- (4) details of the issuer's board of directors approval for the issue of the derivative warrants and any other necessary approvals or consents;
- (5) on the front cover a prominent and legible risk disclosure statement as follows:

“Investors are warned that the price of the warrants may fall in value as rapidly as it may rise and holders may sustain a total loss of their investment.



Prospective purchasers should therefore ensure that they understand the nature of the warrants and carefully study the risk factors set out in this document before they invest in the warrants”.

- (6) a statement of all of the risks which are material for an investor to make an informed decision in respect of investment in warrants;
- (7) a statement of the amount and brief details of any outstanding issues of derivative warrants made by the issuer; and
- (8) if the issuer or guarantor is regulated a statement of the fact, identifying the regulatory body, or if the issuer or the guarantor is not so regulated, a statement of the fact.

5.4.4 There is an additional requirement in respect of non-collateralised warrants to include a warning that the warrants constitute unsecured contractual obligations of the issuer and holders will be relying on the creditworthiness of the issuer and have no rights under the warrants against the company which has issued the underlying securities.

5.4.5 The Exchange proposes to require a description of their risk management systems and policies to be disclosed in the listing documents of non-collateralised warrants.

5.4.6 In order to provide investors with more up-to-date financial information on a warrant-issuer the Exchange proposes to require the additional inclusion of 6 monthly interim unaudited consolidated financial statements.

## **5.5 Analysis of Overseas Regulation**

5.5.1 How overseas regulators regulate the issue of equity warrants are helpful in determining what warrants should be the subject of a class exemption and what conditions of exemption should be imposed.

5.5.2 The policy and justifications of regulation of equity warrants overseas is discussed

below in determining possible criteria and conditions for the application of a class exemption from the Act

## **6 HOW SHOULD EQUITY WARRANTS BE TREATED?**

### **6.1 Class Exemption for Issuers of Equity Warrants**

6.1.1 It is appropriate to consider whether the Commission should facilitate the development of a market in equity warrants by appropriate use of the exemption power in light of the difficulties of compliance with the Act and the Regulations that warrant-issuers may face, in a manner which is still consistent with the treatment of other securities under the Act.

### **6.2 Application of Class Exemption for Equity Warrants**

6.2.1 The important criteria to determine whether to invest in specific equity warrants are likely to be:

- (a) the warrant-issuer's experience and financial strength;
- (b) the financial strength of the issuer of the underlying securities;
- (c) the number, distribution and marketability of the warrants and of the underlying securities; and
- (d) the presence of a security or trust arrangement for the underlying securities or, as appropriate, for the cash settlement.

#### *Warrant-Issuer's Experience and Financial Strength*

6.2.2 The Securities Act is based on attaining public disclosure of relevant information. Imposing value judgements on the suitability of individual warrant-issuers or to set quality standards for the purposes of a class exemption would be inconsistent with this disclosure philosophy.

6.2.3 However the creditworthiness and experience of a warrant-issuer will be an important factor for investors in determining whether to invest in a specific issue of equity

warrants and therefore would appear important that this information is disclosed. Possible disclosure requirements are discussed below at 6.4.7.

### *Underlying Shares*

- 6.2.4 Australia and the UK will only permit underlying securities which are a class of listed equity securities or a class of equity securities listed or dealt in another regulated and regularly operating open market.
- 6.2.5 In Hong Kong the underlying shares must be of a company listed on the Exchange and may only form the underlying security if the total market capitalisation and market capitalisation of such shares in public hands is, at least, HK\$10 billion and HK \$5 billion respectively. This effectively restricts the issue of warrants to the shares of “blue chip” companies.
- 6.2.6 The object in those countries of imposing minimum total market capitalisation and public float criteria is to limit the issue of equity warrants to companies of a particular size on the basis that the shares of such a company will have sufficient liquidity not to be affected by the issue of equity warrants. It also means that the issue of equity warrants is restricted to shares considered to be less susceptible to market manipulation.
- 6.2.7 The question arises as to whether any exemption policy should be restricted to offers of equity warrants in respect of the equity securities of listed companies that are listed on a recognised exchange in New Zealand, or overseas, at the time the warrants are offered to the public. In these circumstances there should be information readily available to warrant-holders through the public domain about the issuer of the underlying security.
- 6.2.8 It has been the experience of overseas investors that the issue of warrants is only successful when there are high ranking underlying securities. The question is whether the Commission should intervene by imposing criteria as to the underlying security to be met before the exemption would apply, or to leave it for the market to determine the most suitable underlying security, the most suitable warrant terms and the most suitable terms of trading in warrants on the basis of disclosure of all material information on the issue of and during the life of the warrants.

6.2.9 The Commission also recognises that transactions are occurring off the stock exchange and it may not be appropriate to restrict the exemption policy to listed companies as issuers of the underlying securities. However if the issuer of the underlying security is unlisted the public information available about that issuer may at present be very limited and could cause difficulties in complying with exemption conditions about the disclosure of information. This may be alleviated by imposing a condition that the warrant-issuer is required to procure copies of financial information on a continuous basis, for all warrant-holders, in respect of underlying securities.

*Number, Distribution and Marketability of the Warrants*

- 6.2.10 It is technically possible for there to be obligations under naked warrants for more underlying shares than have been issued. Many overseas regulators restrict the maximum number of shares of an issuer underlying all warrants, on issue at any one time, for example, the underlying shares not to exceed 20% of the class of equity security on issue. If a maximum number of shares on issue at any one time is imposed would a first in first served basis be an appropriate way of determining who can issue such warrants.
- 6.2.11 Some overseas regulators impose an additional lower limit on the number of placees. This assists in promoting the broader distribution of an issue and results in wider availability thus ensuring that an active market exists in equity warrants. Australia requires that issuers shall ensure that the initial issue of warrants has a spread of holders which in the opinion of the Exchange is “adequate and reasonable”.
- 6.2.12 Some overseas regulators also impose a maximum number of warrants a placee can hold. Where a substantial proportion of an issue is placed to one party who is a substantial or controlling shareholder of the company whose shares underlie the warrant this may have the effect of generating greater interest in the issue than may otherwise have been the case particularly if such information is used by the issuer in the placing exercise. Furthermore, if the substantial or controlling shareholder sells all or a substantial proportion of the equity warrants back to the issuer after trading commences, the repurchase by the issuer may have an adverse effect on the interests of other holders

of the equity warrants.

- 6.2.13 Without a limit on the maximum number of underlying securities in respect of which a warrant-holder can hold warrants a warrant-holder could acquire control of the underlying company without any disclosure of its interest in respect of the underlying securities as the warrant-holder may not have a "relevant interest" under the Securities Amendment Act. Although covered warrants may be within section 5(1)(f)(iii) of the Act.

#### *Security Arrangement*

- 6.2.14 Overseas regulators regard an issue of warrants as "fully-covered" when the issuer has arranged for a number of underlying securities, which are sufficient to meet the exercise of all outstanding warrants, to be held by an independent trustee for the benefit of the warrant holders.
- 6.2.15 To be fully covered the warrant-issuer shall not be able to exercise control over the shares to transfer or dispose of them other than for the purpose of complying with its obligation in respect of the warrant.

#### *Questions for Consideration in respect of the application of a class exemption*

1. Is it desirable that there should be some form of class exemption from certain requirements of the Act and Regulations in respect of offers of equity warrants?
2. From what parts of the Act and Regulations should the exemption be?
3. Should any such class exemption granted be limited to situations where the warrants will be fully covered?
4. What criteria should be used in determining whether a warrant is "fully covered"?
5. To what underlying equity securities should the exemption relate? Should the exemption apply to offers of equity warrants in respect of the equity securities of all

companies or should the exemption be restricted to warrants relating to equity securities of listed companies.

6. Should the exemption be applicable to equity securities listed on exchanges or over markets other than the NZSE?
7. Should a ceiling be placed on the number of warrants on issue at any one time?
8. Should warrant-holders be required to disclose their interests in respect of the underlying securities under the Securities Amendment Act?
9. Should criteria be imposed for ensuring a spread of warrant-holders, for example, should a lower limit be placed on the minimum number of placees?
10. Should the exemption only apply to covered warrants where the underlying equity securities are subject to a trust or should it also extend to other security arrangements affecting the underlying equity securities?
11. Should there be any condition of exemption about the trustee who holds fully covered warrants, for example, that the trustee is a trustee corporation or person approved by the Commission.
12. Should it be a condition of the exemption that there be a "trustee" appointed in respect of naked warrants and possibly partially covered warrants with roughly equivalent responsibilities of a trustee for debt security holders under the Securities Act?

### **6.3 Desirable Disclosures by Warrant-issuers**

- 6.3.1 The important characteristics of an equity warrant from the investor's perspective are likely to be
  - (a) the price of the warrant relative to the underlying security, the exercise price and other terms of the warrant;

- (b) the market characteristics of the underlying security, including its volatility;
- (c) the soundness of the issuer of the underlying security; and
- (d) the ability of the warrant-issuer to perform its obligations if and when the warrant is exercised.

*Price and other terms of the issue*

6.3.2 In many cases it may not be possible for a warrant-issuer to specify the price of an equity warrant in a prospectus because the price will fluctuate according to a set formula in the course of each day and from day to day. Similarly, the exercise price and exercise date may fluctuate. It is also likely that the pricing formula will itself be confidential and commercially sensitive information.

6.3.3 In the past the Commission has been prepared to grant issuers of equity warrants an exemption from clause 1(4) of the first schedule to the Regulations, which requires disclosure in a prospectus of the price of the securities, on the conditions that:

- (a) the warrant-issuer makes the pricing formula available to the Commission;
- (b) the warrant-issuer does not change the pricing formula in any way during the currency of the offer; and
- (c) the prospectus contains a general explanation of the pricing mechanism and a clear statement of how an investor may ascertain the price at any time during the offer period.

6.3.4 Prospective investors will also be interested in the other terms of the issue and specifically disclosure of any restrictions on the activities of the issuer and any financial covenants affecting the issuer if the issuer of the underlying securities goes into liquidation or their shares are delisted taken over or amalgamated.

*Information Relating to the Underlying Securities and the Issuer of the Underlying Securities*

6.3.5 In many cases the only information available to the issuer of equity warrants about the underlying shares and the issuer of those shares (including financial information) will be information that is in the public domain.

- 6.3.6 In Australia, financial information relating to the issuer of the underlying securities and the underlying securities themselves (other than basic information) is not required to be included in an offering circular relating to warrants. Rather it is assumed that the continuous disclosure regime will ensure all relevant information about the underlying shares is known to the market. This may be true if the underlying shares are listed and quoted on the New Zealand Stock Exchange. However, unlike Australia, there is no continuous disclosure regime under the law in New Zealand and no such regime applying to companies other than listed companies. The underlying issuer will be under no obligation to provide, for example, the annual report of the issuer of the underlying securities to the warrant-issuers.
- 6.3.7 However the issuer of the underlying securities will have to prepare financial statements under the Financial Reporting Act and these will be registered with the Registrar. Therefore it could be a condition of exemption that the warrant-issuer provide a copy of the annual financial statements of the issuer of the underlying securities to warrant-holders.
- 6.3.8 It may be unreasonable to require a warrant-issuer to provide anything other than the annual financial statements and basic details relating to the underlying shares and the issuer of those shares. For this reason it may be appropriate that any class exemption granted contain warnings to the effect that:
- (a) Any information disclosed relating to the underlying shares and the issuer of those shares is publicly available information and that the underlying issuer had no involvement in the offer; and
  - (b) The warrant-issuer does not have access to all the information relating to the underlying shares and the issuer of those shares as as a director or manager of the issuer; and
  - (c) To the best of the knowledge and belief of the issuer (who has taken all reasonable care to ensure that such is the case) the information disclosed is accurate. The issuer accepts responsibility for accurately reproducing publicly



available information. The issuer accepts no further responsibility in respect of such information.

*Information Relating to the Warrant-issuer*

- 6.3.9 As a general rule it will be important that there be full disclosure of the financial strength of the warrant-issuer in any prospectus relating to an offer of equity warrants. Investors will need to be able to assess the ability of that person to meet its obligations (either to deliver the underlying shares or cash in lieu) under the warrants.
- 6.3.10 This kind of information is likely to be of less importance where the warrants are "covered" and there is a direct relationship between the issuer and the person who holds the underlying securities (for example, a trust relationship). It will also be of less assistance to the investors if the issuer is itself merely a shelf company set up for the purpose of issuing the warrants. In these circumstances the warrant-holder will need to look to any cover arrangement and/or the financial strength of any third party guarantor.

*Questions for Consideration in respect of disclosure requirements*

1. Should the Commission grant an exemption from clause 1(4) of the first schedule to the Regulations?
2. What other terms of issue should be required to be disclosed as conditions of an exemption notice?
3. Should anything other than publicly available information about the underlying shares and the issuer of those shares be required to be disclosed?
4. Should it be a condition of the Notice that the warrant-issuer should use their best endeavours to obtain copies of financial information, for all warrant-holders, in respect of unlisted underlying securities?
5. Should it be a condition of the Notice that the audited financial statements that comply

with the Financial Reporting Act will be readily available on request to each warrant-holder in respect of the warrant-issuer during the life of the warrant?

6. Should the Commission be prepared to grant exemptions from the requirements of the First Schedule of the Securities Regulations in respect of Financial Statements about the warrant-issuer.

## **7 Futures Regulation**

- 7.1 There may be classes of equity warrants that would be better regulated under the Amendment Act. The Commission's power in s37(7) of the Amendment Act can be used to bring certain classes of equity warrants within the regulation regime of futures contracts. This could be justified on the basis that equity warrants are functionally similar to future contracts.
- 7.2 Section 38 of the Amendment Act prohibits persons from carrying on the business of dealing in futures contracts unless that person is a member of an authorised futures exchange or that person is authorised by the Commission by notice in the Gazette to carry on the business of dealing in futures contracts.
- 7.3 Authorisations can be in relation to specific futures contracts or futures contracts generally. Conditions can be imposed on the authorisation.

### *Questions for consideration in respect of Futures Regulation*

Is regulation under Part III of the Securities Amendment Act more appropriate in light of the similarity in the substance between futures contracts and equity warrants?