

The covered warrant market

service outline



London
STOCK EXCHANGE

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1) Introduction

The London Stock Exchange is launching a market for securitised derivatives in the UK. This document uses covered warrants, a popular securitised derivative, to show how this service will operate. Covered warrants will expand the range of products and opportunities not currently available in geared products to all investors, especially private clients.

2) What is a covered warrant?

A covered warrant is a proprietary instrument, issued by a financial institution, that bestows on the holder the right, but not an obligation, to buy or sell an asset at a specified strike price during, or at the end of, a specified time period.

Covered warrants may be either Calls or Puts, where a call warrant is analogous to a long position in the underlying and a put warrant is analogous to a short position in the underlying. In terms of contract styles, covered warrants can be European or American style. The former means that the warrant can be exercised only at expiration, whilst in the latter case this can be at any time up to expiry. The holder can exercise the instrument for cash or shares, depending on the prospectus of the issuer.

The gearing inherent in covered warrants means that the purchase price (or premium) is typically less than the price of the underlying on which the warrant is based. As holders will always have a long position, be it with Calls or Puts, the maximum loss is confined to the premium paid, and the exercise is always against the issuer of the covered warrant. Unlike company warrants, covered warrants do not create new shares in issue.

3) What benefits could the covered warrant market offer?

- **Gearing** - this allows an exposure to an underlying share to be taken with less outlay than trading the share itself.
- **Range of underlying** - the Exchange's flexible approach to covered warrants issuance is aimed at ensuring that warrants are available on a broad range of underlying, ranging from bluechip equities to technology securities, overseas securities and indices.
- **Ease of Accessibility** - retail and institutional investors can access trading and settlement in the same way and through the same vehicles as they use for ordinary equity.
- **Transaction costs** — the absence of stamp duty when certain conditions are met, lowering the cost of trading.
- **Risk management** - creating synthetic short positions in the underlying offers opportunities for hedging and asset allocation strategies.

4) Why is the Exchange doing this now?

Over the last decade, covered warrants have grown strongly in continental Europe, and this growth has been driven largely by retail participation. In the UK, awareness of geared products has been reflected in the use of spread betting.

Key changes have taken place in the settlement and listing of covered warrants, which make the development of a widely accessible exchange traded market for covered warrants a possibility. Covered warrants are now eligible for settlement in CREST™ on a delivery-versus-payment (DVP) basis, and the UK Listing Authority (UKLA) has developed rules that extend access to covered warrants beyond specialist investors to retail private clients.

5) Market model overview for UK covered warrants

- The Exchange will support two methods of price discovery and trading:

(i) Order Book

This provides a continuous trading environment centred on order execution against committed principals, effectively an electronic market making structure.

(ii) Retail Service Providers

Issuers may have covered warrants admitted to the Exchange and provide price discovery through mechanisms other than the Order Book, such as the RSP Gateway. Transparency for these warrants will be through the dissemination of reference data and trade reports through LMIL.

- Not all covered warrants have automatic execution through an Order Book.
- The covered warrant market will be contained in a single segment that will be open to all participants. The separation of warrants, between order book and non-order book, will be made at sector level.
- Issuers or their agents will have to ensure that there is price provision for the lifetime of all covered warrants admitted to the Exchange. Liquidity can be provided either by the issuer or by agents acting on their behalf, and need not be the same entity for the lifetime of the covered warrant.
- Covered warrants will not be included in Central Counterparty (CCP).
- Access to the order book will be obtained through the Exchange members existing links and technical infrastructure.

a) Use of the RSP Gateway

The Exchange will make available the use of the RSP Gateway to enable participants to obtain prices and trade warrants that are not on the order book but which are listed and admitted to trading on the Exchange. The RSP Gateway is a separate service that provides a central solution for routing quote and order messages. This allows Private Client brokers to interact directly with RSPs (or market makers), on a one-to-one basis, replicating a service that is familiar to retail brokers in equity markets. The service is accessed using Extranex, the Exchange's new Internet Protocol (IP) communication service.

A broker seeking a price in a warrant will send an electronic message to the RSP (in this case, the issuer, or their agent). The RSP will then respond with a price, which can be accepted or rejected by the broker. Should the price be accepted, both parties will be notified, and trade reports will to be submitted. For more information on the RSP Gateway see the London Stock Exchange's website at www.londonstockexchange.com/techlib/rsp_gateway.asp.

6) Operation of the Order Book

a) Price formation and order interaction

- Best bid and offer prices will be formed by Committed Principal (CP) two-way orders, specifying price and size, on the order book. All CP orders will be displayed with the identity of the CP (as this entity may not be the issuers themselves).
- Aggressors will be price-takers, using aggressor orders to trade against, and thereby accept, the price given by a CP.
- Price-Time priority for orders will be maintained for both aggressive and CP orders. The procedure and circumstances for changing CP order details will be outlined by the Exchange.

b) Order types

- The four order types used in the initial release of the market will be:
 - (i) Committed Principal orders
 - (ii) At best orders (unpriced)
 - (iii) Fill or Kill (either priced or unpriced)
 - (iv) Execute and Eliminate (priced)
- Committed Principal orders (CPs) will be used exclusively by CPs, and are input to make a two-way price on the order book.
- Non-CP participants will only be able to use aggressor orders: At Best, Fill or Kill and Execute and Eliminate, ensuring that no portion of an aggressor order is left on the book. Limit orders will not be used in the initial market release.

c) Registration and obligations of committed principals

- Each CP will be registered as such with the Exchange for each warrant issue in which they provide liquidity and prices, and there is no restriction on the number of issues in which a CP can provide liquidity.
- Any automated input facility (AIF) used by a CP to trade covered warrants must be registered with the Exchange for this market, regardless of whether it has been registered for other instruments.
- To ensure effective and efficiently run markets, each liquidity provider will have to fulfil a series of obligations, which will be imposed through regulatory means:
 - CP orders must be in a specified minimum size, the volume of which will be the Normal Market Size (NMS) of the covered warrant issue. The NMS value will be specified by the Exchange.
 - The CP will be required to maintain a size of one NMS on the order book for both the bid and offer quotes.
 - Only one CP order may be input per side per CP.

- Maximum spread rules will be applied, either the greater of **10%** on the bid price or 1p.
- The regulation of CP obligations will be monitored by the Exchange.

d) Order constraints

- For aggressors, the minimum order size is one covered warrant. This will be imposed by system functionality.
- A single tick-size will be used for all warrants, and will not be reviewed quarterly. The tick size is to be 0.01p
- The tick-size value outlined above are generic and apply to all currencies.
- An NMS value of 10,000 will be used for all warrants. There will not be a quarterly review of warrant NMS.

e) Trading day

- The trading day for a covered warrant will typically be referred to as the Mandatory Committed Principal Period (MCP). Committed Principal orders will be mandatory whilst the underlying is in continuous execution and the home market of the underlying is open and voluntary at other times e.g. during auction call phases for the underlying.

For covered warrants based on international underlying, continuous execution will be available between 08:15 and 16:30 though CPs are only obliged to place two-way prices during the respective MCP, which is timed to commence with the opening of the underlying market.

Orders placed on the order book outside the MCP are considered to be firm.

Timings of MCPs for covered warrants

Covered Warrant Underlying	Timing of MCP	Sectors affected
UK underlying securities	08:15 to 16:30	UKVW, UKEW
Other European underlying securities	08:15 to 16:00	EVCW, EECW
US underlying securities	14:45 to 16:30	USVW, USEW
Other underlying	08:15 to 16:30	VOCW, EOCW SP1W, SP2W

Table 1

- Trading will be continuous with no scheduled intra-day auctions.
- The trading hours for covered warrants trading on the Exchange that are based on non-UK traded securities will be the same as those for warrants on UK underlying, closing no later than 16:30 GMT.

The trading day for Covered Warrant Order Book

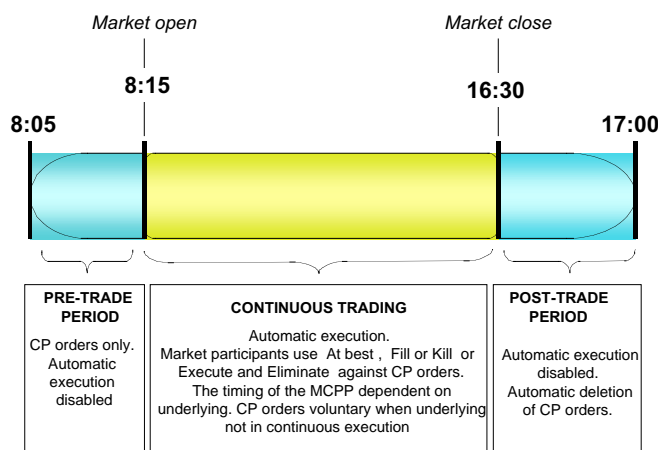


Figure 2

f) Pre-trade period and market opening

- The period between the order-book opening and the commencement of trading, between 08:05 and 08:15, will be for Committed Principals only to enter orders, and automatic execution will be enabled.

g) Post trade period and market closing

- The market close will be at 16:30 when automatic execution is disabled, and the closing price will be based on the mid-price of the closing bid and offer prices.
- The closing price for covered warrants on European underlying instruments (sectors EVCW, EECW) will be taken at 16:00, though automatic execution will be available until 16:30.
- The trading day will not terminate with a closing auction.
- Committed Principal orders will be automatically deleted after the market close.

h) Price monitoring and suspension of trading

- The automatic price monitoring capability will be utilised to limit extreme price deviations. The thresholds will be set at 500 per cent. This reflects the fact that only CPs will have orders on the book at the launch of the market and as the price of a warrant can change rapidly, this will facilitate continuous trading.
- The Exchange will monitor the market in real time.
- Trading in a covered warrant will be suspended if the listing or trading of the underlying is suspended by the UKLA.

- Trading in the covered warrant will not be stopped if the underlying has a price monitoring interruption during continuous trading. Committed Principal orders in this period will be voluntary, but the orders will be considered firm if entered.

i) Trade reporting and publication

- All trades executed on the order book will be reported and published immediately to the market.
- In the event of trades conducted away from the order book, reporting will be required within 3 minutes and trade publication will be immediate.
- Trade reports received after 17:15 will be published at 07:15 on the next trading day.

7) Retail Service Providers

a) Overview

- To support Retail Service Provision, additional sectors will contain reference data and allow reporting and publication.

b) Price formation and order interaction

- Prices for warrants where automatic execution is disabled will be available away from the central order book and on alternative services such as the RSP Gateway.

c) Order types

- Order entry functionality will be disabled for these warrants, except for a period at the end of day, allowing issuers to enter CP orders for the purpose of setting the closing price. During this period, automatic execution will be disabled.

d) Registration and obligation of liquidity providers

- Only one market maker maybe registered in each warrant where automatic execution is disabled.
- Multiple market makers will be required to facilitate trading throughout the lifetime of their warrants, responding to a price request. This will be maintained between the hours of the order book, 08:15 to 16:30. Trading can, however, take place outside these hours.

e) Reference data

- There will be no quote constraints in these sectors but tick sizes and NMS values will be applied to all covered warrant.
- The tick size of all warrants where automatic execution is disabled will be 0.01p
- The tick-size values outlined above are generic and apply to all currencies. For example, if the covered warrants were denominated in Euros then the tick-sizes would be Euro-cents instead of Pence.
- Tick sizes will be fixed at admission and not reviewed.

f) Trading day

- As there is no electronic mechanism on which to trade warrants with automatic execution disabled, the trading day will operate within the same hours as trade reporting, between 07:15 and 17:15, which are also the same hours for RSP Gateway. Issuers are only required to maintain prices in the same hours as the order book, 08:15 to 16:30.

The trading day for covered warrants with Retail Service Provision

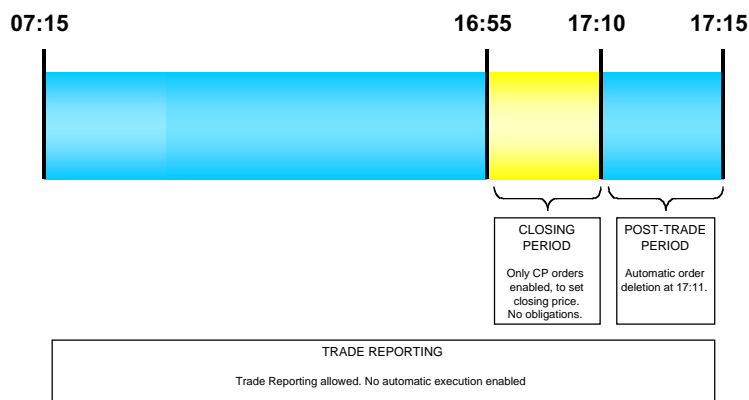


Figure 3

g) Pre-trade period and market opening

- There is no formal pre-trade period and trading can occur at anytime, though the opening will typically begin with the start of trade report publication at 07:15.

h) Post trade period and market closing

- The closing price for warrants where automatic execution is disabled is set at 17:10, though trading can continue after that period in line with equities.
- The trading day will not terminate with a closing auction. Despite order entry being disabled for most of the trading day, there will be a period where CPs are able to enter orders into the system for the purpose of setting closing price. The entry of orders in this period is voluntary.
- Only one CP per warrant will be registered to enter closing prices.
- Closing price will be based on the mid-price of the closing bid and offer prices, and only one bid and offer may be entered for each warrant in the sectors.
- Committed Principal orders will be automatically deleted after the market close.

i) Price monitoring and suspension of trading

- Price monitoring will not used for those instruments where automatic execution is disabled.
- Trading in a covered warrant will be suspended if the listing or trading of the underlying is suspended by the UKLA .
- When a firm price may not exist for an underlying, the Issuer is not obligated to provided liquidity during this period.

j) Trade reporting and publication

- All trades conducted away from the order book will be required to be reported within 3 minutes and trade publication will be immediate.
- Trade reports received after 17:15 will be published at 07:15 on the next trading day.

8) Criteria for admission to the Covered Warrant Market on extraMARK

- The criteria for admittance to the extraMARK covered warrant market
 - The issue must be listed by the UKLA.
 - The issue must be accessible to retail investors.
 - An issuer must ensure that there is liquidity provision for the lifetime of the warrant and must ensure that at least one member firm of the London Stock Exchange provides liquidity for the warrant.
 - The covered warrant must be eligible for electronic settlement in CREST.
- Any covered warrant issue not meeting the above criteria will not be admitted to the covered warrant market on extraMARK.

9) Covered Warrant market tariffs

a) Admission Fees

Admission Fees	
Fee per warrant line per underlying	£500
Minimum fee that applies to each group of warrants on the same underlying on the same day	£1,000
Maximum fee that applies to each group of warrants on the same underlying on the same day	£4,000

Table 1

- There will be no annual fee.

Examples:

Four classes of warrant issued on FTSE100 index issued on same day.

	Fee (£)
4 classes @ £500 per class	2,000.00
VAT @ 17.5% (if applicable)*	350.00
Total admission fee	2,350.00

Ten classes of warrant issued on ABC plc & one class of warrant issued on XYZ plc, issued on same day

	Fee (£)
10 classes @ £500 per class (max £4,000)	4,000.00
1 class @ £500 per class (min. £1,000)	1,000.00
VAT @ 17.5% (if applicable)*	875.00
Total admission fee	5,875.00

- United Kingdom Value Added Tax (VAT), currently at 17.5 per cent, must be added to the fee derived if the issuer is subject to United Kingdom VAT. Issuers are advised to obtain advice on their tax position.

b) Exchange Charges

Covered warrants will be charged as per UK domestic equity.

c) Order and Transaction Charges

Order charge		
	Payer	Charge
Entry	Originator	1p
Deletion	Originator	0p
Transaction Charge		
	Payer	Charge
Transaction charge for each automatically matched trade	Both parties	5p

Table 2

- These prices are correct at time of printing (April 2002), and are subject to change. Participants are advised to consult the applicable Exchange Price List to confirm pricing position.

10) Other areas of the market environment**a) Stamp Duty and other taxation**

- The Stamp Duty position is dependent on whether the covered warrant is exercised for cash or stock. For a cash-settled covered warrant, the investor will receive cash from the issuer. For a stock-settled call covered warrant, the investor receives the underlying stock, whereas cash is received (and stock transferred to the issuer) if a put covered warrant is exercised.
- For an investor, Stamp Duty is chargeable on secondary market purchases of a call warrant exercised for stock and at expiry of that warrant at a rate of 0.5% on the strike price.
- For an issuer, Stamp Duty is charged on secondary market purchases of call warrants exercised for stock and exercising put warrants for stock at a rate of 0.5%, but only where the issuer is not eligible for intermediary relief. The rate is charged on the value of the strike price.
- All other transactions are exempt from stamp duty, namely transaction in calls and puts exercised for cash at expiry. Participants are advised to obtain advice from their tax consultant on their own tax position.

b) Information dissemination and display

- The dissemination of trading and other data associated with covered warrants will utilise Extranex's LMIL⁴ connections as well as existing message types.

- In addition to the information that is currently disseminated by the Exchange for equity securities, additional reference data that is specific to covered warrants will be published. This information will include:
 - the covered warrant strike price
 - the expiry date (and time, if applicable)
 - the ratio of warrants to underlying
 - the expiry settlement type (ie whether it is settled for cash or stock).
- An instrument display name convention will be introduced to allow a succinct display to the market of:
 - the underlying on which the covered warrant is based
 - the covered warrant issuer
 - the contract type (i.e. whether it is Call or a Put)
 - the contract style (i.e. whether it is European or American).
- Information display guidelines will be published separately and explain the display requirements in more detail.

c) Capital treatment of covered warrants for market participants

- Current FSA rules interpret regulatory capital requirements in terms of hedged positions. However, such a position is not guaranteed to obtain 0% capital requirement, and market participants are advised to consult on their status and eligibility for an alternate treatment on capital requirement, which is at the discretion of the FSA.

d) Covered warrant secondary market settlement

- CREST will be used as the settlement depository for secondary market covered warrant transactions, and settlement is conducted under the same procedures as ordinary equity. Both parties to a trade will enter settlement instructions to be enacted for Delivery-Versus-Payment (DVP). T+3 will be the settlement cycle for order book trades. Trades away from the order book will have non-standard settlement cycles.

e) Expiry of covered warrants in CREST

- CREST can be used for the expiry of covered warrants. The current rules governing expiry allow the issuer to choose the procedure, providing it is made explicit in the listing prospectus.
- CREST functionality allows for both automatic and non-automatic exercise in stock-settled and cash-settled calls and puts (stock-settlement is where the warrant holder receives the underlying securities at exercise, whereas cash is received for cash-settled).

Mechanism for automatic exercise at expiry

- Automatic exercise occurs where the issuer initiates expiry unilaterally if exercise is profitable to the warrant holder, without giving notice to the warrant holder. The table below outlines the procedure.

Mechanism for automatic exercise within CREST		
	Calls	Puts
Stock-settled covered warrants	<ul style="list-style-type: none"> The Registrar, on behalf of the issuer, distributes stock to the Holder using an unmatched stock event . The Issuer notifies CREST of the expiry and the warrant issue is deleted from the system. 	<ul style="list-style-type: none"> The Registrar, on behalf of the Issuer, enters an Unmatched Stock Event to credit the Holder s account with cash. The Issuer notifies CREST of the expiry and the warrant issue is deleted from the system.
Cash-settled covered warrants	<ul style="list-style-type: none"> The Registrar, on behalf of the issuer, distributes cash to the Holder using unmatched stock event The Issuer notifies CREST of the expiry and the warrant issue is deleted from the system. 	<ul style="list-style-type: none"> The Registrar, on behalf of the Issuer, enters an Unmatched Stock Event to credit the holder s account with cash. The Issuer notifies CREST of the expiry and the warrant issue is deleted from the system.

Table 7

Mechanism for non-automatic exercise at expiry

- Non-automatic exercise requires both the issuer and the warrant holder to inform CREST of expiry in the form of settlement instructions. This is particularly applicable to American-style covered warrants that are exercised prior to the issue expiry date.

Mechanism for non-automatic exercise within CREST		
	Calls	Puts
Stock-settled covered warrants	<ul style="list-style-type: none"> The Issuer transfers stock to the Holder using a Many-to-Many instruction, which is matched with the Holder s Many-to-Many instruction transferring the warrant to the Issuer. The Issuer may cancel the warrant in its account using a Negative Adjustment instruction or wait until expiry when the issue will be deleted. 	<ul style="list-style-type: none"> The Holder transfers stock to the Issuer using a Delivery instruction. This matches with the Issuer s DEL, transferring cash to the Holder. The Registrar removes the warrant from the holder using a Negative Adjustment instruction or wait until the expiry date when the issue will be deleted.
Cash-settled covered warrants	<ul style="list-style-type: none"> The Registrar, on behalf of the Issuer, and the Holder both enter DEL instructions, exchanging the warrant for cash. The Issuer may then cancel the warrant in its account using a Negative Adjustment instruction or wait until the expiry date when the issue will be deleted. 	<ul style="list-style-type: none"> The Registrar, on behalf of the Issuer, and Holder both enter DEL instructions, exchanging the warrant for cash. The Issuer may then cancel the warrant in its account using a Negative Adjustment instruction or wait until the expiry date when the issue will be deleted.

Table 8

- Market participants are advised to confirm their settlement arrangements with CREST directly. Separate participants codes may be required by issuers to facilitate settlement at expiry and issuers must have a mechanism of informing CREST of unilateral exercise for automatically exercised warrants.

11) Next steps

Brokers and issuers should contact the business development helpline on +44 (0)20 7797 3456 (STX 33456) for further copies or queries.

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