



CONSULTATION PAPER NO. 59

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PROPOSED CHANGES TO DEFINITIONS OF INVESTMENTS

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Why are we issuing this paper?

1. The DFSA proposes changes to the current definitions of Investments to ensure that new and hybrid financial products are appropriately categorised for regulatory purposes. The opportunity is also taken to remove some unintended consequences and anomalies found in the current definitions of Investments.
2. This Consultation Paper details proposed changes to the definitions of Investments in App2 of the General (GEN) module of the DFSA Rulebook (see Appendix 1 to this paper). Consequential changes to the Glossary (GLO) and Offered Securities Rules (OSR) modules of the Rulebook resulting from the proposed changes are set out in Appendices 2 and 3 respectively. To support those changes, appropriate transitional arrangements will be included in chapter 9 of GEN.

Who should read this paper?

3. The proposals in this paper would be of interest to Persons:
 - (a) carrying on, or considering carrying on, Financial Services in or from the DIFC;
 - (b) issuing, or proposing to issue, Investments; or
 - (c) seeking to include Securities in an Official List of Securities.

How is this paper structured?

4. In this paper, we set out:
 - (a) the background to the proposals and overview (paragraphs 8 – 13);
 - (b) removal of anomalies and inconsistencies (paragraphs 14 – 15);
 - (c) proposed changes to expand and rename Designated Investments (paragraphs 16 – 18);
 - (d) a discretionary power to deal with emerging new financial instruments (paragraphs 19 – 23);
 - (e) consequential changes (paragraphs 24 and 25); and
 - (f) transitional arrangements (paragraph 26).

How to provide comments?

5. All comments should be forwarded to the person specified below. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

What happens next?

6. The deadline for providing comments on the proposals is **1 October 2008**. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We will issue a notice on our website telling you when this happens.

Comments to be addressed to:

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Terminology in this paper

7. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in GLO or in the proposed amendments. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

Background

8. The proposed amendments to the definitions of Investments are designed to ensure that financial instruments in the DIFC will continue to attract an adequate and appropriate level of regulation, particularly as new or hybrid instruments emerge that do not neatly fit within conventional product boundaries. The emergence of new or hybrid instruments is not a unique phenomenon as it is the natural result of competitive pressure arising from the competing demands of investors for better returns, intermediaries for better margins and for lower cost of capital by the end users of capital.
9. Additionally, the proposed amendments are designed to ensure that our Investments definitions are in line with the practice in comparable jurisdictions. Entities in the DIFC may wish to issue or deal in, or admit to an Official List of Securities of an Authorised Market Institution, new or hybrid instruments, particularly those emanating from their home jurisdictions under regulatory requirements that are both appropriate for, and comparable with, the requirements that exist in their home jurisdictions.
10. In reviewing the definition of Investments and in particular the manner in which they address new instruments, the DFSA has examined approaches adopted in comparable jurisdictions. These include the United Kingdom, Australia, Malaysia, Hong Kong and Singapore.
11. The DFSA envisages that the proposed amendments will facilitate a more effective and efficient capital market in the DIFC, increase the suite of products capable of listing and or trading on an Authorised Market Institution, and enhance the DIFC's reputation as an international capital market.

Overview

12. Investments in the current Rules are divided into two main categories: Securities and Derivatives (see GLO module). App 2 of GEN contains the definitions of discrete types of Securities and Derivatives; i.e. Shares, Debentures, Warrants, Certificates, Options, Units, Futures, Rights and Interests and Designated Investments. Options and Futures fall within the category of Derivatives. Shares, Debentures, Warrants, Certificates, Units, Rights and Interests (other than those in respect of Derivatives) and Designated Investments fall within the category of Securities.
13. The key changes now proposed are:
 - (a) removal of anomalies and inconsistencies in the definitions;
 - (b) expansion of the current category of Designated Investments to capture structured or synthetic products that are referenced to underlying factors other than Share indices, and the renaming of the category to "Structured Products"; and

- (c) introduction of a discretionary power so that, where necessary, the DFSA may declare an instrument to fall within one of existing categories of Investment or, in the case of an instrument that does not neatly fit within an existing category, to be a new type of a Security or Derivative.

Removal of anomalies and inconsistencies

- 14. We propose to remove anomalies and inconsistencies in the existing definitions. These include:

- (a) Warrants and Options – removal of the current overlap between a Warrant and an Option by confining the scope of a Warrant to be an instrument which confers on the holder a right to acquire an *unissued* Share, Debenture or Unit (the latter was not previously included). In contrast, an instrument conferring a right to acquire an existing, i.e. *issued*, Security by way of transfer of that Security will remain within the scope of the definition of an Option. Proposed Guidance under both Warrant and Option is provided (see Rules A2.2.1(c) and A2.3.1(a));

- (b) Futures – a number of clarifications relating to the definition of a Future as follows:

- (i) A key concern that has arisen about the current definition of a Future is whether certain types of contracts are included. Specifically, whether the first limb of the current definition (which covers commodity futures) excludes any over the counter (OTC) negotiated contract from comprising a Future. We propose to remove this uncertainty by expressly including any additional criterion that serves as a test on whether a contract would be reasonably regarded as being made for investment rather than commercial purpose. As subjective (purpose-based) tests are hard to establish, we have included the ‘reasonability’ test as an objective test, rather than relying on the actual intent of the contracting parties. Proposed Guidance deals with non exchange traded contracts made for investment rather than commercial purpose;
- (ii) We propose to clarify that settlement by physical delivery under a commodities contract would not necessarily preclude it from comprising a Future, and will add Guidance which reflects the language used in the Futures definitions under the UK regime; and
- (iii) We propose to add Guidance to deal with certain types of contracts such as contracts for difference, credit default swaps and forward rate agreements. See Rule A2.3.1(b)(ii) (which covers financial futures);

- (c) Debentures – a number of clarifications and refinements to the definition of Debentures as follows:

- (i) the proposed definition expressly acknowledges that a Debenture can be secured or otherwise (Rule A2.2.1(b));
- (ii) removal of the conventional labels from the definition of Debentures and their inclusion instead as Guidance;
- (iii) addition in Guidance of a reference to Islamic *Sukuk* instruments which may be structured to have the effect of a corporate bond; and

- (iv) clarification in Guidance that a debt instrument does not cease to be a Debenture simply because the interest or other financial return on it is to be calculated by reference to a variable underlying factor. A corresponding clarification on this point is also included under the exclusions from Futures in A2.3.1(b)(ii)(D);
- (d) Rights and Interests – the removal of “Rights and Interests” as a specific category of Investments and the inclusion of a statement in the definitions (see the last sentence of Rule A2.1.1(1)) to ensure that such a right or interest, to the extent it is not already covered by another definition (such as Certificates), is regarded for regulatory purposes as the respective Security or Derivative to which that right or interest relates. An example of such a right or interest is an interest in a syndicated loan. To the extent the syndicated loan is a Debenture, the rights of the holder would be regarded as rights in respect of a Debenture; and
- (e) Certificates – the inclusion of Units as Securities over which a Certificate can be issued. In addition, the language of the definition will be amended to reflect certificate arrangements more accurately (see Rule A2.2.1((d)).
15. We also considered whether it would be beneficial to have discrete definitions for commodities futures (Rule A2.3.1(b)(i)) and financial futures, such as contracts for differences (Rule A2.3.1(b)(ii)). We decided to retain the current structure which covers both types of instruments under the generic heading of Futures as any change to this structure would require more extensive changes to existing Financial Services licences.

Issues for consideration

Do any of these proposed changes cause any practical difficulties? If so, what are they and how should they be addressed?

Do you think that the definition of Options should be expanded to cover an Option over an index (i.e. an index Option), interest rate or other similar reference? Would you have any concerns if the Options definition were to capture such instruments? If so, what are those concerns and how should they be addressed?

Do the proposed definitions of a Warrant and Certificate capture the appropriate types of underlying investments?

Should there be a separate category of Derivatives to capture more exotic types of derivatives, such as weather derivatives? What other types of exotic products should be included in that category? How should such products be distinguished from other types of standardised or exchange traded Derivatives?

Proposed changes to expand and rename Designated Investments

16. Currently, only one type of structured product, ie: Share index tracking products, is treated as a Security under the heading Designated Investments. We propose to expand this category to capture a range of instrument which essentially have a similar economic effect but different underlying factors. While the range of underlying factors by reference to which the holders' profits or losses can be determined would be expanded beyond a DFSA approved index

of Shares to cover property of any description, an index, interest rate, exchange rate or a combination of any of these (ie. a basket), some of the key features of Designated Investments would be retained.

17. In particular, the proposals require public availability of information relating to the underlying factors by reference to which investors' profits and losses under the contract are determined. This promotes transparency of the performance of the underlying factor and removes from the definition any contractual arrangements where the parties' entitlements are determined by reference to individually negotiated, and often complex, calculations which are not suitable for treatment as tradable Securities. We also propose to retain the current restrictions which prohibit gearing and contingent liabilities to arise under such contract. These are considered to be inherent features of Derivatives rather than Securities.
18. We also noted that varying terminology is used in different jurisdictions to categorise these products. We propose the use of "Structured Product" as the most appropriate and generic term that captures the various products envisaged under this category. This term is consistent with the prevailing practice in some other jurisdictions.

Issues for consideration

Is renaming the category as "Structured Products" appropriate? If not, what other term is more appropriate to describe these products?

Does the proposed definition capture all the products that should be treated as a Structured Product within the broader definition of Security? If not, what are those products and why should they be included?

Does the proposed definition include any products that should not be included? If so, why?

Do you have any concerns about the proposed requirement that there should be publicly available information relating to the underlying factor? If so, what are those concerns and how should they be addressed?

Do you think that the proposed prohibitions against leverage and contingent liabilities arising out of the contract are too restrictive? If you think that one or both of those restrictions should be removed, why are you of that view? If there are any concerns arising from the removal of those restrictions, how should they be addressed?

Do you think that Structured Products should not be confined to cash settlement only or alternatively permit physical delivery of the underlying? Would you have any concerns if physical delivery is permitted?

Proposed discretionary power

19. As noted at the outset, emergence of new products in financial markets is a continuing trend. Such products may not, in the future, neatly fit within the existing definitions. To encourage product innovation while ensuring appropriate regulation of new products, we propose to include in the Rules an express discretionary power enabling the DFSA to declare new or hybrid products as a particular type of an existing Security or a Derivative, or a new type of Security or Derivative (see Rule A2.4.1(1)).

20. The key features of this proposed power are as follows:
- (a) The DFSA may exercise this power on its own initiative or upon application by a person (see Rule 2.4.1(2));
 - (b) We propose to specify a range of factors to be taken into account by the DFSA in the exercise of this power. The DFSA may also consider other relevant factors. The specification of matters will assist applicants in preparing their applications (see Rule A2.4.1(3) & (4)); and
 - (c) Prior to the exercise of the power, the DFSA will undertake public consultation of at least 30 days except in certain specified circumstances (see Rule A2.4.1(5)(a), (b) or (c) and paragraphs 21 and 22 below).
21. The DFSA expects to use this power infrequently, particularly given the proposed clarifications to the existing definitions and the significant expansion of the new Structured Products category to capture a wider range of instruments. Generally, to determine when it is appropriate to exercise this power, the DFSA will monitor emerging new financial instruments and trends in financial markets. For example, this power may be used when new types of financial instruments emerge which, though having the economic effect of an investment, do not fit within any particular category of existing definitions. In such cases, the DFSA may use this power to create a new category of an Investment definition to capture those instruments. Generally, such a declaration would be made following prior public consultation, except where the DFSA determines that any delay resulting from public consultation is prejudicial to the interests of the DIFC or, for reasons of commercial expediency, the dispensation of public consultation is considered warranted.
22. The DFSA may also use this power to declare a financial instrument falling within more than one category of existing definitions of Investments to be a particular type of a Security or Derivative as defined in these Rules. However, when making such a declaration, the DFSA is not required to undertake any prior public consultation since the instrument is already within the definition of Investments.
23. No specific appeal rights are proposed in respect of declarations made pursuant to this Rule for two reasons. First, where the DFSA undertakes public consultation, any person whose rights, interests or legitimate expectations may be adversely affected would have an opportunity to make representations to the DFSA. Second, where public consultation is not required or is dispensed with by the DFSA pursuant to Rule A2.4.1(5)(a), (b) or (c) appeal rights are considered inappropriate because of the need to ensure certainty for issuers and users of an instrument once it is declared as a particular type of a Security or Derivative and the possible detriment to such issuers and users by the subsequent removal of such a declaration.

Issues for consideration

Do you have any concerns about this discretionary power or any aspect of it, including the parameters within which the DFSA can exercise that power? If so, what are they and how should they be addressed?

Consequential changes to GLO and OSR

24. Changes to the GLO module will be required to reflect the proposed changes to the definitions. Also, some of the key aspects of current definitions in the GLO module will be relocated into the GEN provisions. For example, the distinction between Securities and Derivatives currently in the GLO module will relocate to the GEN definitions under these proposals (see Rules A2.1.1(1), A2.1.2 and A2.1.3).
25. Some consequential changes to the OSR module will be made to accommodate the proposed changes flowing from the revised “Structured Products” category. It is expected that a wider range of products than currently included under Designated Investments will be captured as Structured Products, thereby enabling their inclusion in an Official List of Securities of an Authorised Market Institution and consequently, subjecting them to the OSR module. Accordingly, the obligations currently imposed on Reporting Entities of Designated Investments will apply to Reporting Entities of Structured Products.

Issues for consideration

Do you have any concerns about the proposed consequential changes to GLO and OSR modules? If so, what are they and how should they be addressed?

Transitional arrangements

26. The DFSA expects to introduce transitional (and saving) provisions that enable issuers of currently traded Investments on an Authorised Market Institution, and persons who are carrying on any Financial Service relating to any particular type of a Security or Derivative, to be able to continue without any undue interruption to their activities, if the proposed changes were to come into effect. For example, the transitional provisions would allow any Person whose licence authorises him to carry on any Financial Service in respect of Designated Investments to be able to do so in respect of Structured Products.

Issues for consideration

Do you have any concerns about this approach to transitional arrangements? If so, what are they and how should they be addressed?