

# Equity Derivatives 2019

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First published 2016

Fourth edition

ISBN 978-1-83862-101-8

Printed and distributed by

Encompass Print Solutions

Tel: 0844 2480 112



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# Equity Derivatives

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Latham &amp; Watkins LLP

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Lexology Getting The Deal Through is delighted to publish the fourth edition of *Equity Derivatives*, which is available in print and online at [www.lexology.com/gtdt](http://www.lexology.com/gtdt).

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured.

Lexology Getting The Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at [www.lexology.com/gtdt](http://www.lexology.com/gtdt).

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We would like to thank the contributing editors, Witold Balaban, Rafal Gawlowski, Catherine Lee and Reza Mojtabae-Zamani of Latham & Watkins LLP, for their assistance with this volume. We also extend special thanks to John M Brandow, Ray Ibrahim and Mark M Mendez of Davis Polk & Wardwell LLP, who contributed the original format from which the current questionnaire has been derived, and who have helped to shape the publication to date.



London

June 2019

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This article was first published in June 2019

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# Overview

**Witold Balaban, Rafal Gawlowski, Catherine Lee and Reza Mojtabae-Zamani**

**Latham & Watkins LLP**

The past several years have witnessed the continuing growth of strategic equities as part of corporate finance advisory services for both listed issuers and their controlling shareholders. Strategic equities services offer a range of equity derivatives products to clients, including capital-raising, equity-linked products; structured share buy-back and share accumulation products; and hedging and monetisation products. This fourth edition of the *Equity Derivatives* volume in the Lexology Getting the Deal Through series aims to survey the equity derivatives landscape in key jurisdictions around the world and highlight the critical issues that practitioners and market participants should be aware of. This introduction gives a brief overview of the state of the global market and the primary product classes discussed in this volume.

When considering which jurisdictions are relevant to the legal analysis of a particular equity derivatives product, practitioners must look beyond the jurisdiction of the counterparty to the product's contract. In addition to considering the laws of the counterparty's jurisdiction, practitioners must consider the laws of the jurisdiction in which the underlying equities are listed and traded (likely to be the jurisdiction in which the equity derivatives product is going to be hedged), the laws of the jurisdiction in which the underlying issuer is organised and in which it conducts business, the laws of the jurisdiction in which the collateral is held, the laws of the jurisdiction in which the dealer is organised and regulated, and the laws governing the equity derivatives product itself. Not infrequently, an equity derivatives transaction will span a number of jurisdictions and will require collaboration among practitioners around the globe.

Efficient equity derivatives markets depend on liquid equity markets, making the US, Japan, greater China, continental Europe and the United Kingdom natural centres for equity derivatives trading. According to data obtained from the World Federation of Exchanges, as of December 2018, the New York Stock Exchange (NYSE) remained the largest exchange operator worldwide, with market capitalisation of approximately US\$20.68 trillion, followed by the Nasdaq Stock Market (US\$9.76 trillion), Japan Exchange Group Inc (US\$5.30 trillion), the Shanghai Stock Exchange (US\$3.92 trillion), Hong Kong Stock Exchanges and Clearing Limited (US\$3.82 trillion), Euronext (US\$3.73 trillion) and the London Stock Exchange Group (US\$3.64 trillion).

The equity derivatives most commonly used by listed issuers are capital-raising, equity-linked derivative securities (such as convertible notes); products for hedging those derivative securities; and accelerated share repurchase transactions. Issuances of equity-linked derivative securities surged in 2018 in an environment of rising interest rates, with convertible note issuances exceeding pre-economic crisis levels. Asian companies, in particular, have issued convertible notes at a record pace. Non-US issuers of American depository shares have successfully raised capital via convertible securities offerings and have employed the related derivative hedging strategies described below. In addition to raising capital through traditional offerings of equity-linked convertible and exchangeable notes, issuers have also marketed alternative structures to investors, including convertible preferred shares, mandatory convertible preferred shares and tangible equity units (a combination of a prepaid stock purchase contract and an amortising note that mirrors the economics of a convertible note). As these convertible securities have approached maturity, structured exchange transactions with existing convertible note holders

have provided issuers with an efficient method of refinancing their convertible debt. Additionally, recent changes in NYSE and Nasdaq listing rules have offered issuers more flexibility to offer convertible notes and related hedging transactions without having to obtain shareholder approval.

Derivative overlays that synthetically raise the conversion price of convertible securities – namely, call spreads and capped calls – remain popular for US issuers, who enjoy favourable tax and accounting treatment. While that treatment may not be available to non-US issuers, many non-US issuers still use capped calls to hedge against potential dilution or cash expenditure upon conversion of the underlying securities, and such issuers can take advantage of alternative structures with potentially more favourable features for which tax integration and accounting concerns are not constraining factors. Call spreads and capped calls have been adapted to hedge a range of other equity-linked securities in addition to convertible notes.

Additionally, US issuers rapidly increased their equity repurchase activity in 2018, spurred by additional cash on hand from tax cuts passed in December 2017. Many of these repurchase programmes have taken the form of accelerated share repurchase transactions, in which a dealer delivers borrowed shares to the issuer against prepayment by the issuer shortly after execution, and the final number of shares to be delivered by the dealer at maturity is determined over a calculation period in which the dealer buys shares in the open market to cover its short position. Although buy-backs have generated significant media coverage over the past year, Goldman Sachs estimates that much of the activity is fairly concentrated; 10 firms in the S&P 500, primarily in the information technology and financial sectors, accounted for 64 per cent of the buy-back growth in 2018. Buyback activity also increased significantly in Japan, although US issuers still repurchase significantly more equity than Japanese issuers or European issuers. Chinese authorities have sought to encourage share buy-backs to boost market valuations. Chinese companies were previously barred from repurchasing their shares except in limited circumstances, but are now allowed to fund buy-backs with bank loans and bond sales, including convertible bonds. China has also loosened requirements for shareholder approval for stock buy-backs.

Controlling shareholders most commonly use margin loans as a pure monetisation strategy for their ownership position. This product class provides preferred means for controlling shareholders to obtain liquidity from their holdings without losing upside (or hedging downside risk) in the stock price or their controlling position. The collateral underlying these margin loans may itself be equity derivative products, including convertible notes, convertible preferred shares or other derivative securities.

Outside the margin loan market, funded collars, prepaid forwards, mandatory exchangeable trust securities and other derivative structures allow controlling shareholders to monetise their positions while hedging against future price fluctuations of the equities they own. In addition, investors have used accelerated accumulation and disposal transactions to acquire or make outright dispositions of their stakes. As non-US shareholders have increasingly used these products, more complex structures have emerged to adopt the US technology for cross-border transactions.

The market for strategic equities services is likely to continue to expand in 2019 and beyond, but the growth of particular product

classes will be shaped by traditional macroeconomic influences, such as global growth; equity prices and liquidity; interest rate changes; and tax, regulatory and accounting policies. In addition, new market entrants and disruptive technologies are challenging the way that many equity derivative products have historically been structured and marketed. Corporate finance advisory services and their clients will need to be prepared to adapt to rapidly evolving market practices and an increasingly globalised landscape.

# United States

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## 1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Typical issuer equity derivatives products include the following:

- accelerated share repurchase (ASR) products allow an issuer to accelerate the purchase of its shares by entering into a forward on its own stock with a dealer in connection with which the dealer borrows shares in the stock lending market, shorts them back to the issuer and covers its short position over a calculation period by buying shares in the open market;
- bifurcated call spread and unitary capped call products allow an issuer of convertible debt to raise the effective strike price of the convertible debt's embedded call option;
- bond hedge products allow an issuer of convertible debt to issue synthetic debt through the combination of the bond hedge and convertible debt;
- a variety of share repurchase products entered into at the time of pricing a convertible debt issuance, including all the above-listed products, allow the underwriter to facilitate hedging by convertible debt investors and the issuer to repurchase its stock;
- issuer borrow facilities, structured as issuer share loans or zero strike call options between an issuer and the underwriter of the issuer's convertible debt allow the underwriter to facilitate hedging by convertible debt investors;
- registered forwards between an issuer and the underwriter of its common equity allow the issuer to lock in equity financing for future acquisitions or other purposes, while retaining flexibility to cash settle the forward with the underwriter rather than issuing stock;
- convertible notes, convertible preferred stock and tangible equity units allow an issuer to raise capital in the most effective way from the tax, accounting, cash flow, corporate or regulatory perspective; and
- sales of shares combined with a purchase of a capped call from the underwriter allow an issuer to raise equity financing at a smaller discount to the market price and limit dilution.

Typical equity derivatives products that allow a shareholder to acquire a substantial position in a publicly traded equity or to monetise or hedge an existing equity position include the following:

- structured margin loans allow a borrower to finance an acquisition of shares or to monetise an existing shareholding;
- calls, puts, covered calls, collars, collar loans and variable prepaid forwards allow a holder to both finance and hedge an acquisition of synthetic long exposure to a stock or to hedge and monetise an existing shareholding;
- put and call pairs, cash-settled or physically settled forwards and swaps allow a holder to acquire synthetic long exposure to the underlying stock, which may be transformed into physical ownership of the stock at settlement;
- 'reverse ASRs' allow shareholders to accelerate dispositions of shares in a manner that minimises its impact on the market price;
- sales of shares combined with a purchase of a capped call from the underwriter allow a shareholder to dispose of its shareholding at

a smaller discount to the market price and retain some upside in the stock;

- mandatory exchangeables, such as trust-issued mandatories, holder's own balance sheet mandatories or borrowed balance sheet mandatories, allow a shareholder to monetise and hedge a large equity position while minimising a negative impact on the share market price.

## 2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

Many equity derivative transactions depend on a liquid stock borrow market to allow participants to hedge their exposure under the transaction. For example, arbitrage funds investing in convertible notes and dealers hedging the upper warrant in a call spread may both need at certain points during the transaction to establish a hedge position by short selling shares borrowed from stock lenders. The convertible notes indenture and warrant agreement almost always have certain protections for those arbitrage funds and dealers to handle situations in which the stock borrow market becomes illiquid or shares may be borrowed only at a high cost. Such situations may occur where M&A activity has been announced and increased demand for borrowed shares, or where issuers have conducted significant repurchase activity and reduced the available free float.

To sell short in the US, the seller's broker must locate a security to borrow to cover the sale, as 'naked' short selling is prohibited. Short sales of securities in the US are subject to the general anti-manipulation rules under the Securities Exchange Act of 1934 (the Exchange Act) and Regulation SHO. As the Securities and Exchange Commission (SEC) has noted, the vast majority of short sales are legal, but abusive practices to create actual or apparent active trading in a security or to depress the price of a security for the purpose of inducing the purchase or sale of the security by others is prohibited. Regulation SHO requires generally that:

- short sale orders being placed with a broker-dealer be marked as such;
- subject to certain limited exceptions, if a stock on any trading day declines by 10 per cent or more from the stock's closing price for the prior day, short sale orders may be displayed or executed for the remainder of that day and the following day only if the order price is above the then-current national best bid;
- broker-dealers must have reasonable grounds to believe that a stock may be borrowed before executing a short sale order; and
- brokers and dealers that are participants in a registered clearing agency must close out any positions within a specified period after a seller fails to deliver securities to the buyer when due.

In addition, section 16(c) of the Exchange Act prohibits insiders from selling common stock that they do not own (section 16 of the Exchange Act does not apply to holders of equities in 'foreign private issuers', which are issuers listed in the US filing their annual reports on Form 20-F). This prohibition covers not only traditional short selling, but also applies to derivative transactions that are 'put equivalent positions' (for example, sale of a call or purchase of a put, or both).

**3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?**

The primary laws surrounding OTC equity derivative transactions between dealers (and between market participants generally), have traditionally been the Securities Act of 1933 (the Securities Act) and the Exchange Act, and in particular the registration requirements of section 5 of the Securities Act, the anti-fraud and anti-manipulation provisions of sections 9 and 10(b) of the Exchange Act and the short-swing profit rules applicable to insiders under section 16 of the Exchange Act. While the SEC administers the rules promulgated under those sections, private rights of action may attach, some of which are prosecuted by active plaintiffs bars. Inter-dealer transactions must comply with these rules in the same manner as trades with non-dealer counterparties. For example, dealers must ensure that their long hedge positions do not cause them to become section 16 'insiders' by virtue of holding more than 10 per cent of an issuer's common stock. Section 16 is not applicable in the case of 'foreign private issuers'.

Since its passage in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) has imposed additional requirements on market participants. The Dodd-Frank Act established a regulatory regime for swaps and security-based swaps. Depending upon the type of equity derivative, such trade may be a swap, a security-based swap, or both. Swaps are subject to the jurisdiction and regulatory oversight of the Commodity Futures Trading Commission (CFTC) and security-based swaps are subject to the jurisdiction and regulatory oversight of the SEC. Certain OTC equity derivatives, such as physically settled swaps and forwards and equity options, are excluded from the 'swap' and 'security-based swap' definitions and, as a result, are not subject to the Dodd-Frank Act requirements.

Most of the requirements governing swaps and security-based swaps apply to swap dealers or security-based swap dealers, which are entities that deal in such instruments above a de minimis threshold. These requirements include registering with the CFTC or SEC, as applicable, maintaining certain levels of capital, reporting the details of transactions to data repositories, maintaining certain records, collecting and posting margin, clearing and execution requirements applicable to certain trades and complying with certain business conduct standards.

Although the Dodd-Frank Act mandated the implementation of a security-based swap regulatory regime (which would regulate dealers in the security-based swap market), the SEC has still not finalised this regulatory regime. As a result, while the expectation is that similar requirements will be applicable to security-based swap dealers in respect of security-based swaps, as those currently applicable to swap dealers in respect of swaps (discussed above), security-based swaps are currently only subject to margin requirements under the Dodd-Frank Act when a US prudentially regulated swap dealer is transacting in such OTC equity derivative – and any additional SEC requirements applicable to security-based swaps by virtue of their also being securities.

In addition to Title VII of the Dodd-Frank Act, the Volcker Rule, which is set forth in Title VI of the Dodd-Frank Act, generally prohibits 'banking entities' (as defined therein) from, among other things, engaging in proprietary trading in financial instruments, such as securities and derivatives, unless pursuant to an exclusion or exemption under the Volcker Rule. Accordingly, the Volcker Rule's proprietary trading prohibition may, in the absence of an applicable exclusion or exemption under the Volcker Rule, restrict certain underwriting, market-making and risk-mitigating hedging activities when a 'banking entity' is acting as dealer. The Bank Holding Company Act of 1956, as amended, may also place additional restrictions on banks acting as dealers that should also be taken into consideration.

Foreign broker dealers that wish to transact with US entities without having to register under the Exchange Act may also need to comply with the 'chaperoning' requirements under Rule 15a-6 under the Exchange Act.

Other applicable regulations include those imposed by securities exchanges; rules enforced by the Financial Industry Regulatory Authority, Inc (FINRA), a self-regulatory organisation for its broker-dealer members; rules enforced by the National Futures Association, a self-regulatory organisation for swap dealers and certain other CFTC registrants; rules implemented by the International Swaps and Derivatives Association, Inc (ISDA); and, as applicable, various

regulatory margin and capital requirements imposed by the SEC, the CFTC or a prudential regulator, such as the Federal Reserve Board or the Office of the Comptroller of the Currency.

Notwithstanding that most swap regulatory obligations fall on dealers, regulations do require that all counterparties obtain and maintain a 'legal entity identifier' prior to entering into, and throughout the life of, any OTC equity derivatives transaction that is a swap.

**4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?**

The entities most commonly facing dealers in equity derivative trades are public company issuers and various types of counterparties holding or acquiring publicly traded shares (such counterparties generally have to own at least \$10 million of assets). Publicly traded issuers frequently utilise equity derivatives to hedge their equity-related obligations, such as call spread and capped calls to hedge against potential dilution from conversions of convertible securities. The issuer may also be involved in setting up a stock borrowing facility to facilitate certain hedging activities by its convertible note holders, or executing through a forward contract an accelerated share repurchase of its common stock to achieve certain financial and strategic goals. Counterparties with large equity stakes often enter into equity derivative transactions to monetise or hedge their holdings, or both. Examples of pure monetisation transactions includes margin loans, while prepaid forward contracts and funded collars can be used to simultaneously monetise the position and hedge against future price fluctuations. Counterparties may also use equity derivatives to accumulate large equity stakes in public companies or to gain synthetic exposure to such equities.

**5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?**

In practice, because most non-dealer counterparties to equity derivative transactions are typically listed issuers, hedge funds, private equity funds, and other sophisticated and well-funded market participants, there are few additional requirements for them to transact with the investment banks and their broker-dealer affiliates that normally act as dealers in such transactions. These non-dealer counterparties will normally easily qualify as 'eligible contract participants', as defined in the Commodity Exchange Act (CEA) and 'accredited investors', as defined under the Securities Act. In certain instances, particularly where the counterparty is a wealthy natural person rather than an investment fund or other legal entity, the dealer may need to conduct additional due diligence to ensure that the counterparty meets those requirements. Dealers may also have to determine that a recommended transaction is 'suitable' for its customer under FINRA rules. Finally, antitrust rules may also come into play where a third party is using the derivative to accumulate a large stake in the issuer.

**6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?**

Yes. If the dealer in the OTC equity derivative sells the issuer's shares into the public market in connection with an equity derivative to which either the issuer or its affiliate is a party, then that sale must either be registered or exempt from registration under the Securities Act. The procedures for registering a dealer's short sales or conducting such sales pursuant to an exemption from registration are set out in a series of SEC no-action letters dealing with certain hedging and monetisation transactions.

Determining a party's affiliate status is critical to structuring any OTC equity derivative. Under the Securities Act, an 'affiliate' of an issuer is a person that directly, or indirectly through one or more intermediaries or contractual arrangements, controls or is controlled by, or is under common control with, the issuer. Whether 'control' exists depends on the facts and circumstances, and typically involves an analysis of a person's aggregate shareholdings in the issuer, presence on the issuer's board of directors, veto rights over certain corporate actions, and other factors. 'Control' over an entity does not require a majority of the voting power over such entity; rather market participants typically consider there to be a rebuttable presumption of 'control' at 10

per cent of the issuer's voting power, and a nearly irrefutable presumption of 'control' at 20 per cent of the issuer's voting power (although the presumption can be overcome based on certain facts and circumstances – for example, if the relationship between the issuer and the 20 per cent holder is openly hostile). The same general thresholds and presumptions apply to voting power on the board of directors. However, a combination of significant voting power as a shareholder and control of board seats may suggest 'control', even though both are below 10 per cent.

#### **7 May issuers repurchase their shares directly or via a derivative?**

Yes, and both types of repurchase transactions are common. There are relatively few requirements for issuers to repurchase their own equity (although under state law, contracts by an issuer to repurchase its shares while insolvent are generally voidable or void), and US issuers tend to repurchase more of their own shares than do issuers in Europe and Asia. In addition to typical 'agency' transactions where a broker-dealer will repurchase shares in specified amounts at specified prices in the open market for a commission, ASR transactions are popular with US issuers. These transactions allow issuers to repurchase their shares at a discount to the average market price over a specified calculation period by 'selling' the volatility in their stock to the dealer. The issuer benefits by buying its shares back at a discount, and the dealer profits to the extent it is able to purchase the shares during the calculation period at less than the discounted price (which depends on the stock remaining volatile during the course of the trade). The issuer also benefits because the dealer typically delivers around 80 to 85 per cent of the shares underlying the transaction shortly following execution, which has an immediate impact on the issuer's earnings per share. Other structures, such as capped and collared forwards, capped calls and issuer put options are also common.

These transactions (including hedging activities of the dealer in connection with an ASR) are structured to avoid the anti-manipulation provisions of section 9 of the Exchange Act and the anti-fraud provisions of Rule 10b-5 under section 10(b) of the Exchange Act. Rule 10b-18 under the Exchange Act offers a safe harbour from certain types of manipulation claims for an issuer if the issuer repurchases its shares in accordance with certain manner, timing, price and volume conditions. ASRs are typically structured such that the dealer's hedging activity would comply with Rule 10b-18 if the safe harbour were available to it. Trades involving certain of the issuer's 'affiliated purchasers' (as defined in Rule 10b-18) may also be structured to meet the requirements of Rule 10b-18.

In addition, section 10(b) of the Exchange Act and Rule 10b-5 thereunder are anti-fraud provisions concerning purchases and sales of securities. Regulation M under the Exchange Act (Regulation M) addresses certain activities that could be viewed as artificially impacting the price of an offered security. It prohibits an issuer or selling security holder engaging in a 'distribution' of its securities, and participants in such distribution and affiliated purchasers, from bidding for or purchasing the securities being distributed or related securities during a 'restricted period' applicable to the distribution.

#### **8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?**

The main risks that dealers face are (i) the imposition of the 'automatic stay' under the US Bankruptcy Code that would prevent them from collecting against their counterparty, (ii) the inability to rely upon the bankruptcy default provisions (called *ipso facto* provisions) in the ISDA Master Agreement as the basis for terminating and closing out the transaction, and (iii) the counterparty's potential status as a 'bankruptcy affiliate' of the issuer. Under section 362 of the US Bankruptcy Code, if a bankruptcy petition is filed in respect of the counterparty, an automatic stay goes into effect that prevents other parties from collecting on pre-bankruptcy claims and taking other actions against the counterparty, including foreclosing on any collateral. The automatic stay is generally intended to help the debtor counterparty preserve its assets, to maximise the assets' value and to ensure that creditors are repaid in an orderly and equitable manner. In addition, under section 365 of the Bankruptcy Code, if a bankruptcy petition is filed in respect of the counterparty, parties to contracts with the counterparty are

prevented from exercising contractual rights to terminate or modify such contracts based on the counterparty's bankruptcy or financial condition. If these provisions were applied to equity derivative contracts, the automatic stay and the inability to terminate the contract would expose the non-debtor dealer to the risk of price movements in the underlying stock, which could force non-debtor dealers into financial distress, causing them to default on their contracts with other parties. To mitigate the risk of a domino effect, certain classes of protected contracts are exempted from these provisions (both the automatic stay and the prohibition on the enforcement of *ipso facto* defaults), including 'securities contracts' (which term includes margin loans) and 'swap agreements'. In addition to concerns about the automatic stay and bankruptcy termination rights, dealers entering into transactions with certain large shareholders may face the risk that their counterparty could be a 'bankruptcy affiliate,' meaning an 'affiliate' (as defined in the Bankruptcy Code) of the issuer of the equity that is the subject of the equity derivative contract. Under section 510 of the Bankruptcy Code, claims arising under a contract with the issuer of the subject equity or its affiliate (in this case a 20 per cent or more equity holder) for the purchase or sale of equities of the issuer could be subordinated to the level of equity in the issuer's or the affiliate's bankruptcy.

#### **9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?**

Sections 13 and 16 of the Exchange Act are the typical sources of reporting obligations for OTC equity derivatives trades. Sections 13(d) and (g) of the Exchange Act impose reporting requirements on beneficial owners of 5 per cent or more of any registered class of equity securities of a US listed issuer, and section 16 of the Exchange Act imposes reporting requirements on insiders (beneficial owners of 10 per cent or more of any such class of equity securities or a director or executive officer of a US listed issuer other than a foreign private issuer). Under Rule 13d-5 of the Exchange Act, if two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities, such persons will be considered a group and their holdings will be aggregated for the purpose of determining beneficial ownership. Moreover, under Rule 13d-3, a person is deemed to beneficially own all shares that person has the right to acquire within 60 days, including through the exercise or conversion of a derivative security. These sections are generally intended to provide the investing public notice when certain investors have accumulated large blocks of securities of an issuer but they also determine whether a person is an insider for the purposes of section 16 of the Exchange Act (eg, beneficially owns 10 per cent or more of any class of equity securities of a US-listed issuer other than a foreign private issuer).

A shareholder must disclose its ownership within 10 days of becoming a 5 per cent beneficial owner on schedule 13D, which requires the shareholder to disclose, among others, the source of the funds used to make the purchase and the purpose of the acquisition, and must report material changes to its ownership 'promptly' thereafter. In lieu of a schedule 13D, certain 'passive investors' (along with other types of investors) may file a short form schedule 13G with a certification that, among others, the securities were acquired in the ordinary course of business and were not acquired for the purpose of changing or influencing the control of the issuer. A shareholder must report its ownership on becoming a section 16 insider on a form 3 and must report any subsequent changes to its ownership on a form 4. Under Rule 16a-4 of the Exchange Act, the acquisition or disposition of any derivative security relating to equity securities of the issuer must be separately reported on a form 4. Reporting is required even if the derivative security can be settled only in cash.

An issuer selling options or warrants to acquire its shares or securities convertible into its shares in a transaction that is not registered under the Securities Act must report such sales in its quarterly and annual reports and on a current report on form 8-K. The issuer's quarterly and annual reports must also disclose its purchases of shares in connection with a derivatives transaction (for example, an ASR). In addition, if the issuer enters into a material contract in connection with an OTC derivatives transaction, the issuer must disclose certain information about the material contract on a form 8-K.

CFTC swap data reporting regulations (as described in question 28) may also apply to an issuer or a shareholder that is entering into an

OTC equity derivatives transaction that is a swap with a non-US counterparty that is not itself registered with the CFTC as a swap dealer.

**10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?**

Issuers and controlling shareholders avoid entering into transactions during certain 'blackout periods' when they may be in possession (or be thought to be in possession) of material non-public information regarding the issuer or its securities. The principal insider trading laws derive from section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Issuers typically restrict insiders from trading during certain windows when the issuer is likely to be in possession of material non-public information, such as prior to release of earnings. Certain affiliates that may have access to inside information by virtue of holding board seats or through other means may also subject their personnel to the issuer's window period policies to avoid the potential appearance that they may be trading on material non-public information during 'blackout'. However, insiders often enter into Rule 10b5-1 'plans' while not in possession of material non-public information, which generally are structured to allow dealers to trade securities on the insider's behalf while the insider may be in possession of material non-public information, as long as the insider is not able to influence how those trades are effected at that time. Many OTC equity derivatives are themselves structured as 10b5-1 'plans'. Trading effected in compliance with a 10b-5-1 plan provides an affirmative defence to a claim of insider trading, but is not a safe harbour.

**11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?**

Securities acquired directly or indirectly from an issuer or an affiliate of the issuer in a transaction not involving any public offering will be 'restricted securities' in the hands of the acquirer under Rule 144 under the Securities Act, and must be resold after specified holding periods to meet the safe harbour under Rule 144. In addition, any securities sold by an affiliate of an issuer or sold for the account of an affiliate of the issuer (even if the affiliate purchased them in the open market) become what are commonly known as 'control securities' for the purposes of Rule 144 (although the term is not defined in the rule). Additional volume, manner of sale and filing requirements apply to sales of control securities to meet the Rule 144 safe harbour requirements. Securities may be both restricted securities and control securities.

If a counterparty to an OTC equity derivatives transaction is an insider under section 16, then the insider must disgorge to the issuer any profits derived from any purchase and sale of any equity security of the issuer, any derivative security, or any security-based swap agreement involving any such security if the transactions occurred within a period of less than six months, subject to certain exemptions. Amendments, resets, or extensions of derivative securities in many cases may be deemed purchases or sales that are subject to reporting obligations and profit disgorgement under section 16.

**12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?**

OTC equity derivatives raise a number of tax issues. First, the Internal Revenue Service (IRS) may recharacterise the transaction in a manner that is different from its stated form, including by treating the transaction as a transfer of beneficial ownership of the underlying equity for US tax purposes. In addition, complex rules govern the timing and character of payments for tax purposes. Payments to a non-US party may also be subject to withholding. Additional issues, such as integration of instruments, may arise depending on the nature of the transaction.

**13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?**

Market participants are typically most concerned with section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Derivative trades between dealers and issuers or controlling shareholders are often structured such that the dealer is acting as 'principal' for its own account, rather than as the agent of the counterparty. Nevertheless, market participants often deem the dealer's hedging activity to be attributable in some form to the counterparty, since the dealer is engaged in the market activity to facilitate a transaction with the counterparty. Therefore, if the counterparty is in possession of material non-public information at the time of the trade, both counterparty and dealer may have liability for any resulting purchases and sales by the dealer in connection with its hedging activity. Similarly, trades will often be structured such that the dealer's purchases would be made in compliance with Rule 10b-18 if the Rule 10b-18 safe harbour were available to it.

Dealers and counterparties must also ensure that the dealer's hedging activities in connection with trades with issuers and their affiliates do not result in an unregistered offering of securities in violation of section 5 of the Securities Act. Questions may also arise as to whether the freely tradeable shares that a dealer purchases in the open market to hedge a transaction with an affiliate of the issuer may thereby become tainted as 'control securities' under Rule 144, since they were purchased to some degree for the benefit of an affiliate. This analysis flows from the paradigm under the US securities laws that transactions, rather than securities, are registered, and once freely tradeable securities may become tainted if repurchased by an affiliate. These issues require a careful trade-by-trade analysis.

Corporate insiders entering into equity derivative transactions may also be forced to disgorge short-swing profits from trades within six months of one another, and dealers must be careful not to become section 16 insiders themselves in connection with their hedging activity.

**14 What stock exchange filings must be made in connection with OTC equity derivatives transactions?**

An issuer typically must file a listing application with the relevant stock exchange if it may issue new shares in connection with its entry into a derivative contract. This filing requirement arises most commonly in convertible note offerings, in which the shares deliverable to investors upon conversion of the convertible notes, as well as the shares deliverable to call spread dealers upon exercise of the upper warrants, must be approved for listing.

**15 What types of documents are typical in an OTC equity derivatives transaction?**

OTC equity derivatives transactions are typically documented on a 'confirmation' that incorporates the terms of the ISDA Master Agreement and the ISDA 2002 Equity Definitions. While the Master Agreement is normally subject to minimal negotiation and is adopted as a 'form' without any schedule, the confirmations in complex OTC equity derivative trades are typically 'long-form' confirmations that make extensive modifications to the standard terms of the Equity Definitions. For example, the standard terms of the Equity Definition will be inadequate for 'VWAP' trades that are based on volume-weighted average prices rather than closing prices. For funded collars, variable prepaid forwards and other transactions in which the counterparty pledges securities, the confirmations may also contain the collateral terms.

Parties to OTC equity derivatives transactions that are swaps may also be required by their dealer counterparties to adhere to ISDA protocols or similar bilateral documentation for the purpose of complying with various CFTC regulatory requirements.

**16 For what types of OTC equity derivatives transactions are legal opinions typically given?**

Legal counsel will typically render opinions for margin loans, call spreads and capped calls, prepaid forwards, registered forwards and zero-strike call options. Legal opinions are not typically given for ASR transactions, but may be given by local counsel where the

counterparty is a foreign entity. For trades involving lending or pledging of restricted securities or securities held by affiliates of the issuer, counsel will typically be required to give 'de-legending' opinions to allow the securities to be transferred under contractually agreed conditions.

**17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?**

Yes. Registered borrow facilities in connection with convertible notes offerings are one example. Certain convertible note investors that are arbitrage funds will hedge by shorting the shares simultaneously with the purchase of the convertible bond and by purchasing credit protection on the bond through a credit default swap. If there is insufficient stock borrow available for short selling, issuers would have difficulty marketing the convertible notes to such investors. Therefore, in a registered borrow facility, the issuer issues a number of shares which corresponds to the number of shares underlying the convertible bond and lends them to a dealer, which offers those shares in an SEC-registered offering, thereby creating a short position for the dealer. The dealer then transfers this short position to arbitrage funds via cash-settled total return swaps, which in turn allows the arbitrage funds to establish their short position for the convertible notes. For Delaware issuers, the loan fee paid to the issuer by the dealer will be equal to the par value of the shares to comply with state law requirements that the share lending fee for newly issued shares must cover the aggregate par value of the shares.

These transactions must be carefully structured to comply with Regulation M, Rule 10b-5, section 5 of the Securities Act and other applicable restrictions. Moreover, the impact of the market activity by the dealer and the convertible note investors needs to be adequately disclosed.

**18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?**

Most large, complex margin loans and collar loans must be structured around a number of issues relating to the character of the pledged securities and the pledgor. Controlling shareholders often acquire their holdings through private investment agreements rather than a public offering (making such securities 'restricted securities') and also may be affiliates of the issuer by virtue of their large shareholdings or right to board representation (making such securities 'control securities'). Like any other person, a foreclosing lender that wishes to sell securities must either register the sales or comply with an exemption from registration. Although, as described below, lenders may be able to sell the pledged securities pursuant to a registration statement or through other exit options, Rule 144 under the Securities Act is the key safe harbour that lenders seek to rely on to sell the pledged shares publicly without registration.

If the securities are restricted, the seller must satisfy the relevant holding period under Rule 144 prior to the sale – six months since the securities were acquired from the issuer or an affiliate (or in some cases 12 months if the issuer has not satisfied certain filing requirements). If an affiliate pledges restricted securities 'with recourse', the lender or pledgee may include the time that the affiliate or pledgor held the securities prior to the pledge in calculating the holding period. The meaning of the phrase 'without recourse' is subject to much debate and interpretation. Particularly where the pledgor is a special purpose entity, market participants generally consider that a guarantee by a parent entity would be required for the pledge to be considered 'with recourse'.

Because the pledged securities often were not issued in a public offering and are not initially freely tradeable, they are typically held in either in physical, certificated form, or in dematerialised form as restricted book entries on the books of the transfer agent, in each case with legends describing the transfer restrictions. In addition to the securities laws restrictions, these securities are often subject to various 'lock-up' provisions in the related investment agreements that must be drafted to carve out the pledge and foreclosure sale by the lender. Lenders will seek to pre-establish procedures with the issuer and its transfer agent to ensure that, in the event of a foreclosure, the shares can be quickly de-legended (if permissible at the time of foreclosure) and transferred to a potential purchaser or purchasers, preferably through the facilities of The Depository Trust Company.

Lenders may also sell under an effective registration statement, and may require borrowers to pledge their rights under any registration rights agreement with the issuer, although this is not typically a favoured method. The availability of the registration statement can never be assured, there is risk of underwriting liability and potential unavailability of due diligence defences, and lenders may learn about material non-public information not disclosed in a prospectus from affiliate borrowers. Registration rights agreements may also impose lock-up restrictions on parties to the agreement in certain circumstances.

If no 'public exit' is available, lenders may have to dispose of the collateral via private placement, although it will be subject to a liquidity discount and the purchaser will acquire restricted stock.

Lenders often contractually limit the number of shares they can hold on foreclosure (blocker provisions) and the manner in which they can sell those shares (bust-up provisions) to ensure that they do not themselves become an affiliate of the issuer.

**19 If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?**

Under section 362 of the US Bankruptcy Code, an automatic stay takes effect immediately on a debtor's bankruptcy filing and prevents creditors from foreclosing on collateral for pre-bankruptcy claims. However, section 362 enumerates certain classes of protected contracts in respect of which the automatic stay does not apply. 'Securities contracts,' which are defined to include 'any margin loan', are one such class. The term 'margin loan' is not defined in the US Bankruptcy Code, however. Market participants often worry that only those transactions that have been historically characterised as margin loans (ie, buying stock on margin through a broker) qualify as margin loans for the purposes of the definition of securities contracts, and that the more structured and complicated transactions known to equity derivatives participants as margin loans may not be eligible for protection. Careful structuring of a margin loan to make it more like a 'classic' margin loan (eg, ensuring compliance with margin regulations applicable to banks or brokers, ensuring that each lender in a multi-lender facility has individual rights with regard to its portion of the collateral, etc) may afford market participants some comfort that their remedies against a borrower would not be subject to the automatic stay. Judicial interpretation of the phrase 'margin loan' in the context of the US Bankruptcy Code is lacking, so there is uncertainty as to the outcome of any litigation of this issue.

In the light of this uncertainty, market participants are careful to structure margin loans to minimise the risk of a borrower bankruptcy in the first instance. Lenders typically require a would-be borrower to create a new 'bankruptcy-remote' special purpose vehicle (SPV) to serve as the pledgor and borrower. This technique has the benefit of assuring the lender that the borrower has no legacy indebtedness or obligations that could be the impetus for a bankruptcy filing. Lenders also often demand certain separateness and limited purpose provisions in the loan documents and SPV's organisational documents. These provisions generally require the SPV to maintain a separate and distinct existence from any other entity (decreasing the likelihood that the SPV's bankruptcy will be consolidated with that of its parent or affiliates), and prevent the SPV from incurring other indebtedness or obligations and from engaging in any other activities (other than the borrowing and related pledge) that could result in the SPV having any other creditors that could file the SPV for bankruptcy. It has also become standard for a lender to require that the SPV appoint an independent director to be an objective evaluator of fiduciary duties without any biases in favour of the parent, whose affirmative vote is required to, among other things, permit the SPV to file for bankruptcy.

**20 What is the structure of the market for listed equity options?**

The largest US exchange by volume is the Chicago Board Options Exchange (CBOE), which normally accounts for around one-quarter of the total market share. In recent years, approximately 88 per cent of the total options contracts traded have been equity options, and approximately 12 per cent have been index options. Most of the main options

exchanges trade all (or nearly all) equity options, with only the CBOE trading a significant number of index options (approximately 43 per cent in 2017). Securities underlying listed options must be 'optionable' under the rules of the applicable options exchange, meaning that they must meet certain criteria relating to share price, liquidity and other factors.

Although listed options have standardised features, such as the number of underlying shares, strike prices and maturities, certain listed options incorporate various characteristics of OTC equity options. 'FLEX options' allow investors to customise certain terms, such as the exercise prices, exercise styles and expiration dates, while maintaining the benefits of listing and clearing. 'LEAPS options' have longer maturities than typical shorter-dated options, with exercise dates of up to three years in the future.

All listed equity options are issued, guaranteed and cleared by a single clearing agency – the Options Clearing Corporation (OCC) – which is a registered clearing agency with the SEC. The OCC is the largest equity derivatives clearing organisation in the world.

## **21 Describe the rules governing the trading of listed equity options.**

The trading of listed equity options is largely governed by the laws applicable to broker-dealers under the Exchange Act and FINRA rules, as well as the rules and by-laws of the OCC and options exchanges.

Broker-dealers are subject to a number of rules when trading listed equity options for their own account or the account of others, including position and exercise limits for listed equity options imposed by FINRA and exchange rules with respect to proprietary and customer positions. FINRA rules also require FINRA members to enter into agreements with listed options customers containing certain minimum terms, send confirmations and obtain explicit authorisation from a customer before exercising discretionary power to trade in options contracts for the customer.

Exchange rules and systems regulate the manner of trading on the exchange, including the manner in which orders may be submitted to the exchange, market maker quoting, display of orders and the priority of order interaction. Exchanges also establish a range of requirements and prohibitions on members' proprietary and agency activities on the exchange. For example, exchange (and FINRA) rules prohibit trading ahead of customer orders.

Unlike OTC equity options, in which the parties may elect how to determine what adjustments should be made to account for certain corporate events involving the underlying security – such as stock splits or combinations, mergers and acquisition activity or dividend payments – all adjustments for listed options are made by OCC.

## **22 What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?**

All listed equity options must be centrally cleared, and the OCC is the only clearing house for listed equity options traded on all US exchanges.

Equity derivatives that are CFTC-regulated swaps (such as swaps referencing broad-based securities indices or US government securities) must be centrally cleared if the CFTC has issued an order requiring clearing of that category of swap. Certain index credit default swaps (CDS) are currently required to be cleared.

Equity derivatives that are security-based swaps are subject to analogous rules under the Exchange Act. However, as discussed above, the SEC has yet to finalise rules implementing these requirements. As a result, no equity derivatives that are security-based swaps are currently required to be cleared.

## **23 What categories of equity derivatives must be exchange-traded and what rules govern trading?**

Listed equity options must be traded on an options exchange.

Any equity derivative that is a CFTC-regulated swap that is subject to mandatory clearing and has been determined to be 'made available to trade' must generally be executed on a designated contract market, which is a futures exchange registered with the CFTC, or a CFTC-regulated swap execution facility. Currently equity derivatives subject to mandatory clearing and trade execution requirements include certain index CDS.

Equity derivatives that are security-based swaps are subject to analogous rules under the Exchange Act. However, the SEC has yet to

finalise rules implementing these requirements. As a result, no equity derivatives that are security-based swaps must be executed on an execution facility or exchange.

If one or both of the parties to an equity derivatives transaction that is a swap or security-based swap is not an 'eligible contract participant' (as defined in the CEA), then the transaction must be exchange-traded.

## **24 Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.**

### **Swaps and security-based swaps**

Counterparties to uncleared equity derivatives that are swaps or security-based swaps typically document their collateral arrangements using a Credit Support Annex published by ISDA that supplements the ISDA Master Agreement. As described in question 25, under rules issued by US banking regulators and the CFTC, swap dealers (and security-based swap dealers, in the case of the US banking regulators' rules) are (in some cases) and will be (in others) required to collect and post initial and variation margin with certain counterparties in specified amounts, and subject to requirements concerning collateral types, segregation and documentation; the SEC is expected to issue similar rules soon for security-based swap dealers that are not subject to the US banking regulators' rules.

### **Equity options**

For listed equity options, an investor must deposit cash or securities or both as collateral in its brokerage account when writing an option. Options buyers generally do not post margin, but they are required to pay a premium. Initial and maintenance margin requirements for options writers are established by the options exchanges and FINRA rules and vary by option and position type. Broker-dealers carrying customer options accounts may impose higher margin standards than those required by FINRA and the exchanges. The OCC imposes margin requirements on its clearing members with respect to each account maintained at the OCC.

There are no margin requirements imposed by US regulators, exchanges or clearing houses for OTC equity options, and therefore any collateral arrangements are established bilaterally between the counterparties.

## **25 Must counterparties exchange collateral for some categories of equity derivatives transactions?**

### **Swaps and security-based swaps**

#### **Uncleared swaps and security-based swaps**

Swap dealers and security-based swap dealers are, in certain cases, required to collect and post margin pursuant to rules that have been issued by the US banking regulators (which apply to swaps and security-based swaps entered into by bank dealers and certain other 'prudentially regulated' dealers) and the CFTC (which apply to swaps entered into by non-bank swap dealers). The SEC has proposed, but not yet finalised, its uncleared security-based swap margin rules that would apply to security-based swap dealers that are not prudentially regulated by a US banking regulator.

The uncleared swap and uncleared security-based swap margin rules of the CFTC and US banking regulators are in effect for variation margin, and are subject to a phased-in compliance schedule for initial margin, lasting until 1 September 2020, with the precise date for a given counterparty pair depending on the size of derivative portfolios.

Under the CFTC's and US banking regulators' rules, certain counterparties of swap dealers and security-based swap dealers to uncleared swap and uncleared security-based swap transactions may be required to collect or post initial and variation margin. Specifically, all transactions where one counterparty is a swap dealer (or a security-based swap dealer, in the case of the US banking regulators' rules) and the other counterparty is either a swap dealer (or security-based swap dealer, as applicable) or financial end user require variation margin to be exchanged bilaterally. Additionally, if the counterparty facing a swap dealer (or a security-based swap dealer, in the case of the US banking regulators' rules) is a swap dealer (or security-based swap dealer, as applicable) or a financial end user with 'material swaps exposure', the parties will be required to exchange initial margin bilaterally (subject to regulatory minimums). If the counterparty facing a swap dealer (or a security-based swap dealer, as applicable) is not a financial end user, the US banking regulators' rules require that the swap dealer

or security-based swap dealer collect initial and variation margin, as appropriate; the CFTC's rules, on the other hand, do not affirmatively require the collection of initial and variation margin from non-financial end users. Certain swap transactions that are subject to an exemption from the CFTC's mandatory clearing requirement are exempt from the initial and variation margin requirements. Finally, if neither counterparty is a swap dealer (or security-based swap dealer, in the case of the US banking regulators' rules), the margin rules do not apply.

Special rules also apply to certain cross-border transactions, in which certain exemptions are provided for foreign banks (but not their US branches), though these exemptions are subject to many conditions and limitations.

For uncleared security-based swaps with a security-based swap dealer that is regulated by the SEC and not by a US banking regulator, margin rules are not yet in effect. Counterparties to these transactions, however, may determine to exchange collateral bilaterally.

#### ***Cleared swaps and security-based swaps***

For cleared swaps and security-based swaps, the counterparty must comply with the collateral exchange requirements of the particular clearing organisation and the clearing member through which the counterparty obtains access to that clearing organisation, which has requirements that are themselves subject to CFTC and SEC requirements.

#### ***Equity options***

For listed equity options, there is no requirement for the counterparties to exchange collateral, although a listed equity options writer is required to post collateral to its broker-dealer.

Any collateral arrangements for OTC equity options are established bilaterally between the counterparties.

### **26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?**

In general, US securities laws have a broad extraterritorial reach, and any trades with US-listed underlying equities will have to consider the implications of US securities laws even where the counterparties and governing law of the derivative contract are otherwise non-US. US-listed underlying equity in a derivative contract may also create a sufficient nexus to give rise to US bankruptcy considerations. Absent other activities in the US, however, listing equity on a US exchange generally would not subject the issuer to US net income taxation. In addition, certain specific rules may apply to swaps and security-based swaps under the CEA and Exchange Act, and investors in listed equity options generally must comply with requirements imposed by broker-dealers to comply with SEC and FINRA requirements, regardless of their location.

### **27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?**

A dealer entering into equity derivatives that are CFTC-regulated swaps (such as swaps referencing broad-based securities indices or US government securities) must register as a swap dealer if certain of their activities in a dealing capacity exceed stated thresholds (namely, US\$8 billion over a rolling 12-month period, or US\$100 million with 'special entity' counterparties, as defined in the rules). A counterparty that is not required to register as a swap dealer may nonetheless be required to register as a major swap participant and to become subject to rules similar to those applicable to swap dealers if its swap activity exceeds thresholds of current exposure and potential future exposure that are set out in rules; there are currently no registered major swap participants.

Similar registration requirements apply to counterparties to equity derivatives that are SEC-regulated security-based swaps. However, these registration requirements are not yet effective.

A person who acts as a broker or dealer (as defined in the Exchange Act) with respect to options that are securities must register with the SEC as a broker-dealer and must generally become a member of FINRA. Broker-dealers that facilitate transactions in listed equity options may also be required to become members of the OCC and an options exchange.

### **28 What reporting requirements apply to market participants that deal or invest in equity derivatives?**

Equity derivatives that are CFTC-regulated swaps are required to be reported to a swap data repository (SDR). In most cases, the SDR is required to publicly disseminate certain anonymous information about the swap. Swap dealers are also subject to various financial and other reporting requirements.

Similar reporting requirements apply to equity derivatives that are SEC-regulated security-based swaps, but are not yet in effect.

FINRA member broker-dealers are required to report large options positions held by the broker-dealer or any of its customers to the Large Options Positions Reporting System, which is hosted by the OCC. Broker-dealers are also subject to various financial and other reporting requirements.

### **29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?**

Structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares raise issues about the appropriate level of and responsibility for disclosure about the issuers of those shares, baskets or index components. With respect to individual shares or baskets of shares, the SEC staff issued a no-action letter that permits third-party unaffiliated issuers to link to other issuers' shares with minimal incremental disclosure, provided that such issuer satisfies what is referred to as the 'reading room analysis'. If there is adequate publicly available information about the issuer of the linked shares and sufficient market interest in the shares, the prospectus for the structured product may provide a brief description of the nature of the issuer of the underlying stock, and its performance, and may refer investors to that issuer's filings with the SEC for additional information. This 'reading room' principle also extends to baskets. Typically, each basket component is analysed to determine whether it complies with the requirements of the no-action letter, but some issuers may determine that components that comprise only a small part of the basket need not strictly satisfy the requirements. For structured products linked to a broad-based index of third-party stocks, most issuers conclude that disclosure about each component would not be meaningful to investors and do not apply the reading room analysis.

Broad-based indices, whether third party or of a proprietary nature, raise additional disclosure issues in light of regulatory concerns surrounding the complexity and transparency of such indices and accountability of their sponsors. Structured product issuers must ensure that the index disclosure adequately describes the index methodology, as well as any embedded costs and fees and any conflicts of interest. Proprietary indices with limited histories have also attracted regulatory scrutiny. FINRA has a long-standing position that backtested or 'pre-inception performance' data cannot be used in communications with retail investors because it does not comply with FINRA retail communications rules. However, for institutional communications, FINRA permits such data to be provided so long as it is clearly identified as being for institutional use only, the index reflects a rules-based methodology, the backtested data shows a range of market environments, is distinguished from actual historical performance and discloses any limitations of the backtested methodology. In addition to complying with FINRA's conditions, disclosure relating to any proprietary index and its performance is subject to the SEC's standards that such disclosure must not misstate or omit material information. All communications must be presented in a way that is fair and balanced to afford institutional investors the opportunity to make an informed investment decision.

Finally, in addition to disclosure considerations, other legal issues may arise. For example, when a structured product is linked to an index, discretion in the calculation of that index must be carefully analysed, in particular to avoid potential issues under the Investment Company Act and the Investment Advisers Act, as well as ERISA and tax issues. Structured products linked to shares of a US third-party corporation (or a basket or index that includes such shares) may give rise to special withholding issues for non-US holders. In addition, if the methodology for rebalancing the underlying shares in a basket or index (regardless of whether shares of a US corporate equity are included) permits a degree

of discretion, changes in the composition of the basket or index may be a taxable event to a US holder of the structured product. Separately, the parties to structured products linked to discretionary baskets or indices may be required to report the transaction to the IRS. If a global distribution is contemplated, EU benchmark regulation and IOSCO principles for financial benchmarks may also be implicated when linking to third-party or proprietary indexes.

### 30 Describe the liability regime related to the issuance of structured products.

Issuers and other deal participants involved in offerings of structured products face potential liability for material misstatements or omissions, as well as for failing to register the sale of the structured product with the SEC (if required) or complying with one of the exemptions from registration. In addition, potential liability under state securities laws and common law fraud may arise in connection with offers or sales of securities.

In particular, for SEC registered offerings:

- section 11 of the Securities Act provides a cause of action if any part of a registration statement contained an untrue statement of a material fact or a material omission at effectiveness. Potential defendants include the issuer, directors, signing officers, named experts and underwriters;
- section 12 of the Securities Act provides a right of rescission to investors against any person who offers or sells a security by means of a prospectus or oral communication that includes an untrue statement of a material fact or a material omission, or if a security is offered or sold in violation of the Securities Act's registration requirements.

For both SEC-registered and unregistered offerings:

- Rule 10b-5 claims of an untrue statement of a material fact or an omission of a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading may also arise; and
- Rule 10b-5 claims require fraudulent intent, or scienter (unlike claims under section 11 or section 12).

Given increasing technology-driven efficiencies, awareness of regulations and potential liability in other jurisdictions where such products may be offered or sold is also important.

### 31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

The majority of convertible security issuances are in the form of convertible notes, which are convertible at the option of the holder under certain circumstances. Typically, conversions may be settled in cash, stock or a combination thereof at the issuer's election, depending

on the accounting treatment the issuer desires. Foreign issuers who have listed American depositary shares (ADSSs) in the US may also raise capital through securities convertible into their listed ADSSs. In some cases, issuers choose to employ call spread or capped call derivative overlays to synthetically increase the conversion price of the notes and reduce potential dilution. The derivative overlays can be structured such that the premium paid by the issuer (normally not tax deductible) will be treated as tax deductible additional interest expense on the convertible debt, and the derivative instruments will receive equity accounting treatment rather than being treated as marked-to-market derivatives.

Most convertible notes are offered on an unregistered basis only to large 'qualified institutional buyers' that are not affiliates of the issuer under rule 144A of the Securities Act, making them 'restricted securities' that generally cannot be resold to the general public unless one year (or six months if certain of the issuer's filing requirements are met) has elapsed since the original issuance. Issuers typically agree to remove restrictive legends to allow public sales after one year, although the market for convertible notes is dominated by such qualified institutional buyers and may be traded among such entities under rule 144A prior to de-legending. In certain circumstances issuers will issue convertible notes in a 144A offering simultaneously with a registered equity offering, in which event issuers must structure the transactions such that the unregistered convertible notes offering is not 'integrated' with the registered equity offering.

In a registered offering, the issuer must simultaneously register the offering of the underlying equity if the convertible securities are convertible within one year (almost always the case). In both a registered and an unregistered offering, an exemption from registration is generally available for the issuance of the underlying securities on conversion under section 3(a)(9) of the Securities Act. In an unregistered offering, the shares received on conversion are restricted securities, but the holding period of those shares may be 'tacked' to the holding period of the convertible securities for the purposes of rule 144's holding period requirement.

Convertible notes issuances may generate short selling by certain investors in the notes to hedge their position, as well as market activity by dealers under the call spread or capped call transactions, which must be disclosed in connection with the offering. Issuers may have to comply with stock exchange rules requiring shareholder approval where the number of shares into which the convertible security are convertible would exceed 20 per cent of the shares outstanding, unless certain exemptions are met.

Mandatory convertibles are treated as forming the same class as the underlying shares and therefore may not be offered under rule 144A and are generally offered on a registered basis. In this case, the issuer must simultaneously register the offering of the underlying equity.

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For tax purposes, a mandatorily convertible note may be characterised as equity, rather than debt. If so, among other consequences, the issuer would not be allowed to deduct interest expense and coupon payments would be subject to withholding when paid to a non-US holder. Even without recharacterisation, an issuer's deduction of interest payments may be limited for mandatory convertibles and certain optional convertibles, and, in the case of a US issuer, may be limited or disallowed, based on the use of the proceeds. Further, US holders may need to recognise dividend income and non-US holders may have to pay withholding tax, even if no payment has been made, if conversion ratio is adjusted and certain conditions are met.

**32 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?**

Exchangeable securities are exchangeable into securities of an entity different from the issuer of the exchangeable security, and are often issued by a capital-raising entity that is a subsidiary of the issuer of the publicly traded common equity.

Exchangeables may also be offered on a registered basis or an unregistered basis if an exemption from registration is available. For the exemption from registration under section 3(a)(9) of the Securities Act to be available for the issuance of the underlying securities issued upon exchange, the issuer of the exchangeable security must be a wholly owned subsidiary of the underlying shares issuer and its parent must fully and unconditionally guarantee its obligations. Absent

such an arrangement, the exchange must be registered at the time of the exchange or qualify for a different exemption. If the underlying shares are 'free stock' (underlying shares that are not restricted and not owned by an affiliate of the issuer), the exchange does not have to be registered, whether the exchangeable securities are offered on a registered basis or pursuant to Rule 144A. Where these conditions are not met, the only practical alternative is to offer the exchangeable security under Rule 144A, effect the exchange on a private placement basis and register resales of the underlying shares, since tacking under rule 144 is not permitted in this situation.

Mandatory exchangeables may be offered on a registered basis, which requires registration of the underlying shares unless they are free stock. Mandatory exchangeables may be offered under Rule 144A only in certain circumstances where the underlying shares are free stock, the mandatory exchangeable can only be settled in cash, and other technical requirements of Rule 144A are met.

For tax purposes, an issuer's deduction of interest may be disallowed for mandatory exchangeables and certain optional exchangeables if the exchange is for shares of a third party (especially if the third party is an affiliate of the issuer). Further, interest payments may be subject to withholding when paid to a non-US holder. Unlike the conversion of a convertible security, an exchange will generally be a taxable event for the holder and the issuer.

\* *The authors would like to thank associates at Latham & Watkins LLP, Ashley Weeks, Marc Langer and Zoey Wu, for their contribution to this article.*

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