Equity Derivatives

Contributing editors

John M Brandow, Ray Ibrahim and Mark M Mendez

2016

GETTING THE DEAL THROUGH

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First edition

Getting the Deal Through is delighted to publish the first edition of *Equity Derivatives*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

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 **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured.

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.gettingthedealthrough.com.

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.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, John M Brandow, Ray Ibrahim and Mark M Mendez of Davis Polk & Wardwell LLP, for their assistance in devising and editing this volume.

GETTING THE DEAL THROUGH

London
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Introduction

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Even as the equity markets worked through a difficult stretch globally in 2015, the equity derivative markets continued to play an important role for financial institutions, companies, investors and individuals. As the regulatory landscape develops further and market participants look for new ways to structure equity-linked transactions, hedge equity-related risks, accumulate new equity positions and monetise existing equity positions, we present in 2016 the first edition of the *Equity Derivatives* volume in the Getting the Deal Through series to give those looking to engage in or advise on equity derivative transactions a strong base of knowledge in a number of key jurisdictions.

The regulatory landscape remains ever changing in the equity derivatives space. Worthy of note, the Dodd-Frank Act amended existing US law to establish a comprehensive new regulatory framework for swaps (primarily regulated by the Commodity Futures Trading Commission (CFTC)) and security-based swaps (primarily regulated by the Securities and Exchange Commission (SEC)). When finalised, this regime will include requirements related to reporting, exchange trading, clearing and exchanging margin. Certain equity derivatives will be classified as swaps and others will be classified as security-based swaps. The CFTC's rules are nearly all finalised, while the SEC's rules are primarily proposed but not in final form.

The public-facing side of the equity derivatives business – issuances in the capital markets of convertible debt and preferred shares linked to the performance of the issuer's underlying common shares – saw a decline in 2015 as compared to 2014 in both the number and volume of issuances. Originally, the decision by the US Federal Open Market Committee to raise the federal funds target rate by 25 basis points, along with signalling by the Federal Reserve that rate increases would continue through 2016, was seen as a catalyst for the convertibles market. But jitters in the equity markets throughout Asia that spread into US markets during the first few months of 2016 – particularly in the pharmaceuticals and technology sectors, which are among the high-volatility corporates that often use convertibles to finance a significant portion of their ongoing capital needs – served as a strong counterweight and kept issuances at bay. According to the *Prospect News Convertibles Daily*, the US market saw a decrease in deal volume from US$50.8 billion in 2014 to US$39.5 billion in 2015 (or 22 per cent) and the number of deals shrank by 35 per cent, from 134 in 2014 to 91 in 2015. The non-US market saw similar trends, as issuance volume fell 12 per cent from US$39.2 billion to US$34.6 billion and deal numbers fell 32 per cent from 134 to 91.

However, continued headwinds in the high-yield debt market may spur growth in 2016 for convertibles, especially as those corporates hit by the severe downturn in worldwide commodity prices look for ways to finance their ongoing operations or refinance maturing high-yield debt. And while falling convertible issuances meant fewer derivative products linked to those convertibles, such as call spreads and capped call instruments, issuers continued to employ these strategies to raise (from the issuer's perspective) the effective conversion price of their convertible offerings.

Aided by depressed equity prices, more established corporates continued the trend of using excess cash on their balance sheets to fund repurchases of their common stock. This repurchase activity remained strong in 2015 as shareholders voiced their desire for a return of capital, and large accelerated share repurchases effected through the use of forward contracts continued to be a popular structure with many corporate treasury departments.

Complex margin loan transactions, in which one or more banks lend money to large stakeholders of publicly traded companies with the loans secured by the borrower's underlying equity position, saw further growth as private equity sponsors sought to leverage returns and provide capital to investors. Margin loans should continue to play a large role in the equity derivatives business going forward into 2016 and beyond.

On the structured product side, equity-linked notes continued to dominate the US SEC-registered landscape, accounting for 84.6 per cent of all structured notes volume, or US$36.8 billion, according to Bloomberg. Rate-linked, commodity-linked and other asset classes made up the remaining 15.4 per cent. Even with the sideways US equity markets and despite the ever-evolving regulatory environment, this represented a significant increase over 2014, in which equity-linked notes represented only 77.8 per cent of total volume. Equity-linked notes made up a much smaller percentage of the larger US$170 billion non-US global market in 2015, however.

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?

Common issuer trades, in which the issuer of the underlying equity is a party to the transaction, are:
- accelerated share repurchase (ASR) transactions, in which an issuer accelerates the purchase of its shares by entering into a forward repurchase agreement with a dealer under which the dealer borrows shares, shorts them to the issuer and covers its short position over a calculation period by buying shares in the open market;
- call spread transactions, used by a company that is issuing convertible debt to raise the effective strike price of the convertible debt's embedded call option;
- share loans, share sale and repurchase transactions and zero strike call options entered into between an issuer and the underwriter of the issuer's convertible debt to allow the underwriter to facilitate hedging by convertible debt investors; and
- swaps used by an issuer to hedge its exposure under its employee benefit plans or other equity-related obligations.

Common third-party trades, in which the party transacting opposite the dealer is an affiliate or minority holder of the underlying equity (or a party looking to become such a holder), include:
- margin loans, used to finance or leverage large shareholdings, including shares to be purchased in an acquisition;
- collars, collar loans and prepaid forward contracts used to hedge or monetise shareholdings;
- put and call transactions, forwards or swaps used to acquire an economic interest in a company, including situations in which the company may become a target in a takeover.

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

Many securities in the United States have very robust and low-cost stock borrow markets. While short sales of securities in the United States are subject to general anti-manipulation rules under the Securities Exchange Act of 1934 (the Exchange Act), short sales are also governed in particular by Regulation SHO. Regulation SHO requires generally that:
- short sale orders being placed through 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 of a registered clearing agency must close out any positions within a specified time period after a seller fails to deliver securities to the buyer when due.

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 Securities Act of 1933 (the Securities Act), and the Exchange Act, have traditionally been the most important statutes governing OTC equity derivatives transactions, but the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) (particularly Title VII thereof) has played a large role since its passage in July 2010.

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 Commodities Futures Trading Commission (CFTC) or Securities Exchange Commission (SEC), as applicable, maintaining certain levels of capital, reporting the details of transactions to data repositories, maintaining certain records and complying with certain business conduct standards. Certain OTC equity derivatives, such as physically settled forwards and equity options, are excluded from these requirements.

Dealers in OTC derivatives must consider additional regulations, such as those imposed by securities exchanges on which any underlying securities are listed, namely, the Financial Industry Regulatory Authority, Inc (FINRA), a self-regulatory organisation for its broker-dealer members; rules implemented by the International Swaps and Derivatives Association (ISDA); and various regulatory capital requirements imposed by the SEC or a prudential regulator, such as the Federal Reserve Board or the Office of the Comptroller of the Currency.

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

Issuers of publicly traded common securities are frequent participants opposite dealers, primarily for the purpose of hedging equity-linked obligations they may have, facilitating derivative transactions by market participants through the provision of a share borrow (or similar) facility or accelerating a repurchase of common stock through a forward transaction. Third-party transactions often involve financial services-related counterparties such as traditional private equity funds, growth capital investment funds and sovereign wealth funds, but individual shareholders (usually corporate insiders) participate in many margin loans and prepaid forward transactions. In addition, certain non-financial publicly traded companies have used these transactions as a means to acquire strategic stakes in other publicly traded companies.

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 general, dealers who contract with non-affiliate third parties are subject to the same regulations that apply to inter-dealer transactions. In addition, if the transaction is a securities-based swap, the counterparty must be an 'eligible contract participant', as defined in the Commodities Exchange Act (CEA). In other cases, the counterparty must be an 'accredited investor', as defined under the Securities Act, if the OTC transaction involves the offer or sale of a security to the counterparty. Finally, if the shares underlying the transaction are 'restricted securities' (securities acquired in an unregistered sale from the issuer or an affiliate of the issuer), the dealer should consider whether its hedging activities must be registered under the Securities Act or conducted pursuant to an exception from registration.

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?

If the issuer of the underlying shares or an affiliate of the issuer sells the shares via a derivative, the dealer's short sales to hedge the derivative must be registered under the Securities Act or exempt from registration. Under the Securities Act, an 'affiliate' of an issuer is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the issuer. The procedure for registering the dealer's short sales is set out in an SEC no-action letter issued on 9 October 2003 to Goldman Sachs. A dealer hedging a derivative with an affiliate or a non-affiliate holding restricted securities can follow procedures outlined in another SEC no-action letter issued to Goldman Sachs on 20 December 1999 or in an SEC no-action letter issued to Bank of America Merrill Lynch on 1 December 2011.

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

Section 9 of the Exchange Act prohibits manipulation of security prices and prohibits transactions in a security that create actual or apparent trading activity in, or raise or depress the price of, such security for the purpose of inducing the purchase or sale of such security. In addition, section 10(b) of the Exchange Act and Rule 10b-5 thereunder are anti-fraud provisions concerning purchases and sales of securities. Rule 10b-18 under the Exchange Act provides issuers repurchasing their shares with a safe harbour from certain types of manipulation claims so long as the issuer repurchases its shares in accordance with certain manner, timing, price and volume conditions.

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?

Under section 362 of the US Bankruptcy Code, if the counterparty becomes a debtor, an automatic stay goes into effect that prevents other parties from collecting on pre-bankruptcy claims and taking other actions against the counterparty. In addition, under section 365 of the Bankruptcy Code, if the counterparty becomes a debtor, 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. However, certain classes of protected contracts are exempted from these provisions, including 'securities contracts' and 'swap agreements'. Additionally, under section 510 of the Bankruptcy Code, claims arising under a contract with the issuer or its affiliate (in this case a 20-per-cent or more equity holder) for the purchase or sale of securities of the issuer could be subordinated to the level of equity in bankruptcy. Finally, under state law, contracts by an issuer to repurchase its shares while insolvent are generally voidable or void.

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

A shareholder may have reporting obligations under sections 13 and 16 of the Exchange Act as a result of entering into an OTC derivatives transaction on the issuer's shares. 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 an 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 securities or a director or officer of the issuer). Under Rule 13d-5 under 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 purposes of determining beneficial ownership. A shareholder must disclose its ownership upon becoming a 5-per-cent beneficial owner on Schedule 13D (or, in certain cases, Schedule 13G) and must report material changes to its ownership. A shareholder must report its ownership upon becoming a section 16-insider on a Form 3 and must report any subsequent changes to its ownership on a Form 4 and file an annual statement on a Form 5. Under Rule 16a-4 under the Exchange Act, the acquisition or disposition of any derivative security relating to equity securities of the issuer must be separately reported.

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 Form 8-K.

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?

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit, among other things, a person from purchasing or selling securities 'on the basis of' material non-public information about such securities or the issuer. However, Rule 10b5-1 under the Exchange Act provides an affirmative defence to a claim of insider trading if the person making the purchase or sale demonstrates that the transaction was effected pursuant to a binding contract, an instruction to another person or a written plan, in each case given or entered into in good faith before the person became aware of the material non-public information.

In addition, Regulation M under the Exchange Act 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.

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?

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 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.

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 IRS may recharacterise the transaction in a manner that is different from its stated form. 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?

Aside from liability for breach of contract, the primary source of liability in connection with OTC equity derivatives transactions is section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Because dealers typically purchase and sell the underlying shares to hedge the transaction, both parties may have potential liability for claims that the purchases and sales are, or the equity derivatives transaction itself is, made to manipulate the price of the underlying shares or made on the basis of material non-public information. A dealer may be concerned that the possession of material non-public information by its counterparty at execution of, or when an election is made under, a transaction could be imputed to the dealer if the information affects the dealer's trading activity.

An issuer or underwriter is also subject to liability under the Securities Act in connection with a registered sale of shares made to hedge an equity derivatives transaction.

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

Typically, a stock exchange filing is necessary only where the terms of the relevant derivative may require an issuance of listed securities by the issuer. The issuer must file an application (typically at or prior to execution of the transaction) with the relevant stock exchange for the issued securities to be approved for listing on the exchange.

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

OTC equity derivatives transactions are typically documented using the architecture of the ISDA standard forms, including an ISDA Master Agreement (with or without a Schedule thereto), and one or more trade confirmations subject to that ISDA Master Agreement. The ISDA Master Agreement governs the basic relationship between two parties and provides the basic contractual framework for each transaction thereunder. Often, instead of executing an actual ISDA Master Agreement, the parties will deem their confirmation to be subject to an agreement in the form of the ISDA Master Agreement. If the parties to a transaction expect to enter into more than one transaction of a particular type, the confirmation may take the form of a master confirmation that governs the general framework for the type of transaction, with supplemental confirmations entered into for each specific transaction.

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

Legal opinions are typically given for OTC equity derivatives transactions entered into by an issuer in connection with an issuance of a convertible security, such as call spread transactions, prepaid forward and zero-strike call options. Legal opinions are also typically given where the counterparty is not organised in the United States or is an affiliate of the issuer of the underlying equity. An opinion may also be necessary if an affiliate is pledging or lending shares and restrictive legends must be removed to allow the dealer to use the shares for its hedging activities.

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, but state law requirements must be observed (for Delaware corporations, this means that, in the case of newly-issued shares, the share lending fee must cover the aggregate par value (if any) of the shares), and if the issuer lends its shares to an underwriter for sale to the public, the underwriter's sales of the shares must be registered under the Securities Act.

Repurchase transactions and share loans may raise sensitive market manipulation issues if not structured carefully. For example, if an issuer lends or agrees to repurchase the full number of shares underlying its offering of convertible debt, investors in the convertible debt may short the full number of shares underlying their investment (resulting in an over-hedge) and buy shares in the market to establish the proper hedge position. This may produce a temporary increase in the market price of the shares. Unless the issuer adequately discloses the potential effects of the share loan or repurchase transaction, the issuer and underwriter may be liable under the Securities Act for inadequate disclosure, and the issuer, underwriter or equity derivatives dealer, or all three, may be exposed to claims of manipulative activity under Rule 10b-5.

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?

A foreclosing lender that wishes to sell restricted or controlling shares in a public transaction must either register the sales or comply with an exemption from registration. Rule 144 under the Securities Act provides an important safe harbour from registration for public sales of securities. In the margin loan context, the most important of Rule 144's conditions is that the seller must satisfy the relevant holding period requirement prior to the sale. For restricted securities, the required holding period is six months (or in some cases 12 months) since the securities were acquired from the issuer or an affiliate. There is no holding period requirement for controlling shareholdings that are not also restricted securities, such as shares an affiliate acquires in the public market. If an affiliate pledges restricted securities 'with recourse,' the pledgee may tack the affiliate's holding prior to the time of the pledge to the post-pledge period to determine whether the pledgee's foreclosure sales satisfy the holding period requirement. But if the affiliate's pledge of restricted securities is 'without recourse,' the pledgee cannot tack the period prior to the pledge and will not be able to sell the pledged securities, as pledgee, for at least six months from the time of the pledge. The 'time of the pledge' may not be straightforward if the pledgor is allowed to post additional share collateral, or to substitute collateral, throughout the term of the loan or in a revolving margin loan or delayed draw facility. Additionally, the meaning of the phrase 'without recourse' is subject to much debate and interpretation.

A borrower that is an affiliate of the issuer may acquire material non-public information about the issuer, and lenders strive to avoid receiving this information for internal trading reasons. Further, the borrower's entry into the loan transaction when it has material non-public information about the issuer, or having material non-public information at the time of foreclosure, could expose the pledgee to liability under Rule 10b-5 in connection with any sale of shares.

Restricted and controlling shareholdings are often held in physical, certificated form, with legends describing transfer restrictions. For these shares to be sold publicly, they must be in the Depository Trust Corporation clearing system, which requires de-legending of the shares. A transfer agent and the issuer may require opinions and undertakings from the pledgee to accomplish the de-legending process.

The pledge of a controlling shareholding also raises issues as to whether the pledgee is an 'affiliate' of the issuer by virtue of its rights as pledgee and its resultant ability to create a controlling shareholder through a foreclosure sale. Because status as an affiliate could potentially limit the rest of the pledgee's activities with respect to the relevant issuer, lenders often contractually limit the number of shares they can hold upon foreclosure (blocker provisions) and the manner in which they can sell those shares (bust-up provisions).

19 What is the structure of the market for listed equity options?

In the listed equity options market, all orders must be executed on an options exchange that is registered as a national securities exchange with the SEC. There is no active OTC trading in listed equity options.

Listed options are traded by registered broker-dealers that are members of options exchanges, as principal or as agent. Most exchanges have member firms that act as market makers and that post bids and offers on the exchange in accordance with exchange rules.

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. Executed options trades are submitted to the OCC, which becomes the buyer for every seller and the seller for every buyer, thereby effectively protecting members from counterparty risk. Options positions are reflected on the books of the OCC. Broker-dealers that are clearing members of the OCC maintain accounts at the OCC and investors hold accounts on the books of clearing members directly or indirectly through other broker-dealers.

20 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 customers, 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.

In addition, because listed equity options are securities, they are subject to the anti-fraud and anti-manipulation provisions of the Exchange Act.

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

All listed equity options must be centrally cleared.

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. To date, however, no equity derivatives that are swaps are currently required to be cleared.

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 are currently required to be cleared.

22 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 must generally be executed on a designated contract market (DCM), which is a futures exchange registered with the CFTC, or a CFTC-regulated swap execution facility (SEF), if the swap is subject to mandatory clearing and has been determined to be 'made available to trade'. However, because no equity derivatives that are swaps are currently subject to mandatory clearing, no equity derivatives that are swaps must currently be executed on a DCM or SEF.

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.

23 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 (CSA) published by ISDA that supplements the ISDA Master Agreement. As described below in question 24, under rules recently issued by US banking regulators and the CFTC, swap dealers will be 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 for security-based-swap dealers soon.

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.

24 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 will shortly be required to collect and post margin pursuant to rules that have been issued by the US banking regulators (which apply to bank dealers and certain other 'prudentially regulated' dealers) and the CFTC (which apply to non-bank swap dealers). As of 1 March 2016, 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 subject to a phased-in compliance schedule, between 1 September 2016 and 1 September 2020, depending on the size of the uncleared swap or security-based swap positions with the counterparty.

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 and the other counterparty is a swap dealer or financial end user will require variation margin to be exchanged bilaterally. Additionally, if the counterparty facing a swap dealer is a swap dealer or a financial end user with 'material swaps exposure,' the parties will be required to exchange bilaterally initial margin (subject to regulatory minimums). If the counterparty facing a swap dealer is not a financial end user, the US banking regulators' rules require that the 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, 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.

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

Swaps and security-based swaps

For CFTC-regulated swaps and swap intermediaries, the swaps provisions of the CEA apply to cross-border activities that have a 'direct and significant connection with activities in, or effect on, commerce of the United States' or that contravene rules that the CFTC may prescribe as necessary or appropriate to prevent evasion of the swaps provisions of the CEA. Under the CFTC's Cross-Border Guidance, swap requirements are divided into entity-level requirements, such as swap data record-keeping, risk management and capital requirements, and transaction-level requirements, such as clearing, trade execution and swap trading relationship documentation requirements. Swap dealers must generally comply with all entity-level requirements regardless of their place of organisation. On the other hand, market participants must generally comply with transaction-level requirements only where at least one of the counterparties is a 'US person', as defined in the Cross-Border Guidance. However, there are a number of exceptions to these general rules. For example, transaction-level requirements may apply to transactions between two non-US persons where:

- one counterparty is guaranteed by, or acts as a conduit affiliate for, a US person;
- the non-US swap dealer executes the swap through a US branch; or
- once certain CFTC no-action relief expires, the non-US swap dealer regularly uses US personnel to arrange, negotiate or execute the swap.

In addition, pursuant to the CFTC's 'substituted compliance' framework, parties may in some cases comply with certain non-US rules that the CFTC has determined are comparable to CFTC rules, rather than the corresponding CFTC requirements.

For security-based swaps and intermediaries, section 30(c) of the Exchange Act generally provides that security-based swap requirements are not applicable to the extent a person transacts a business 'without the jurisdiction of the United States', unless such person transacts such business in contravention of rules that that the SEC may prescribe as necessary or appropriate to prevent the evasion of the security-based swap provisions of the Exchange Act. The SEC has proposed rules and guidance interpreting this standard and clarifying the applicability of security-based swap requirements to cross-border transactions. These proposed rules are broadly similar to the rules and guidance contained in the CFTC's cross-border framework, but there are significant differences.

The US banking regulators' uncleared swap margin rules have a slightly different extraterritorial scope than rules governed by the CFTC's and SEC's cross-border framework described above.

Equity options

Options investors must trade listed equity options through a registered broker-dealer. Registered broker-dealers and members of exchanges are subject to most SEC and FINRA rules and the rules of exchanges of which they are members on a worldwide basis. The requirements that broker-dealers impose on their customers as a result of these rules are generally applied regardless of the customer's location.

26 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?

Pursuant to an SEC no-action letter, where there is sufficient market interest in and publicly available information about the issuer of the stock underlying a structured product, the prospectus for the structured product only needs to provide very limited information about the issuer of the underlying stock and may refer investors to that issuer's filings with the SEC (known as the 'reading room analysis'). This 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 comply. Issuers have concluded that the no-action letter does not apply to structured products linked to a broad-based index of third-party stocks on the basis that disclosure about each component would not be meaningful to investors.

Regulatory concerns surrounding the complexity of structured products linked to proprietary indices require issuers to ensure that the disclosure adequately describes how the index works, all costs and fees and any conflicts of interest. Proprietary indices with limited histories have also attracted regulatory scrutiny. While the SEC has not objected to including back-tested historical information in prospectuses, FINRA generally does not permit the inclusion of such information in documents over which it has jurisdiction. Finally, discretion in the calculation of a proprietary index must be carefully analysed, as issues under the Investment Company Act and the Investment Advisers Act, as well as ERISA and tax issues, may arise.

Structured products linked to shares of a US third party (or a basket or index of such shares) may give rise to special withholding issues. If the methodology for selecting the underlying shares permits a degree of discretion, the exercise of such discretion may be a taxable event to a holder of the structured product. Separately, the parties to such structured products may be required to report the transaction to the IRS.

27 Describe the liability regime related to the issuance of structured products.

Deal participants and others 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 particular:

- 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 may also arise, but unlike claims under section 11 or 12, 10b-5 claims require fraudulent intent, or scienter.

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

An optional convertible security gives an investor the right to convert the security into the underlying equity. Conversely, a mandatory convertible security provides for an automatic conversion of the security into the underlying equity at maturity. Conversions may be settled in cash, stock or a combination thereof at the issuer's election, depending on the accounting treatment the issuer desires.

Optional convertibles may be offered on a registered basis or an unregistered basis if an exemption from registration is available. 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 upon conversion under section 3(a)(9) of the Securities Act. In an unregistered offering, the shares received upon conversion are restricted securities, but the holding period of those shares may be 'tacked' to the holding period of the convertible securities for purposes of Rule 144's holding period requirement.

Unregistered offerings of optional convertibles are generally sold to 'qualified institutional buyers' under Rule 144A of the Securities Act, which

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requires that the offered securities not be of the same class as securities listed on a national securities exchange. This requirement is met if the effective conversion premium (as defined in Rule 144A) of the convertible securities is at least 10 per cent.

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.

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. Even without recharacterisation, an issuer's deduction of interest payments may be limited for mandatory convertibles and certain optional convertibles. Further, holders may need to recognise dividend income even if no payment has been made, if certain conditions are met.

29 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 differ from convertible securities in that the issuer of the underlying security is not the issuer of the exchangeable security. Like convertibles, exchangeables may take the form of optional or mandatory instruments. Exchangeable securities are often issued by a capital-raising entity that is a subsidiary of the issuer of the publicly traded common equity.

As with optional convertibles, optional exchangeables may be offered on a registered basis or an unregistered basis if an exemption from registration is available. Except where the issuer of the exchangeable security is a wholly owned subsidiary of the issuer of the underlying shares and the parent fully and unconditionally guarantees the subsidiary's obligations, the section 3(a)(9) exemption is not available for the exchange of the exchangeable security. As a result, 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 exchangables may only be offered under Rule 144A if (i) the underlying shares are free stock; (ii) the underlying shares are not listed on a US exchange or were issued prior to the listing of the shares of the same class on a US exchange; or (iii) the mandatory exchangeable can only be settled in cash. In the situation described in clause (ii), the mandatory exchangeable cannot mature in less than a year, since the investors' holding period for Rule 144 purposes only starts when the mandatory exchangeable is issued.

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. Unlike the conversion of a convertible security, an exchange will generally be a taxable event for the holder and the issuer.

Getting the Deal Through

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