

## SECURITIES ALERT

### REGISTERED HEDGING TRANSACTIONS\*



#### EXECUTIVE SUMMARY

In a recent, significant interpretative letter, the SEC staff facilitated certain derivatives transactions by clarifying the status of such transactions under the registration provisions of the Securities Act of 1933, as amended (Securities Act). *Goldman Sachs & Co.* (Oct. 9, 2003). The types of transactions at issue are forward contracts, options, or a combination of forwards and options (Contracts), entered into between an issuer (Issuer) and an investment banking firm or other counterparty (Counterparty), and related hedging transactions. The principal elements of the derivatives transactions are as follows:

- The Issuer files a shelf registration statement on Form S-3 or F-3 prior to the time it enters into a Contract. (The staff position is available only to Issuers that qualify to make a primary offering on Form S-3 or F-3.)
- The “plan of distribution” section of the prospectus discloses that the Issuer may sell securities in a derivatives transaction and that a Counterparty in the transaction may sell securities covered by the prospectus, including in hedging transactions.
- The Counterparty is deemed an underwriter of the underlying securities that are the subject of the Contract and must be identified as such in the prospectus or in a prospectus supplement.
- After the registration statement has been declared effective, the Issuer and Counterparty enter into the Contract, and the Counterparty hedges its position by executing initial sales of up to the maximum number of shares deliverable under the Contract.
- After the Counterparty sells such maximum number of shares in registered hedging transactions, it may make further sales and purchases of the class of underlying securities in “dynamic hedging transactions” (see below) to bring its position to its desired level. The staff clarified that these sales may be made on an exempt basis pursuant to Sections 4(1) and 4(3) of the Securities Act.

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The staff letter facilitates certain derivatives transactions between an Issuer and a Counterparty because it allows initial hedging transactions by the Counterparty to be made on a registered basis without requiring all related hedging sales to be made pursuant to registration. Registered derivatives transactions can be expected to increase in view of the staff position formalizing a more relaxed approach to these transactions.

## OVERVIEW

Derivatives transactions are an integral and pervasive feature of corporate finance. Investors hedge their positions and/or enter into derivatives transactions with counterparties that hedge their positions in the private or public markets. See, e.g., *Goldman, Sachs & Co.* (Dec. 20, 1999) (*Goldman I*), which allows holders of restricted, control or Rule 145 securities to enter into forward contracts implemented as unregistered public sales in a manner consistent with the terms of Rule 144 under the Securities Act. In a recent, significant interpretative letter, the SEC staff facilitated derivatives transactions made on a registered basis by clarifying the status of related hedging transactions under the registration provisions of the Securities Act. *Goldman, Sachs & Co.*, SEC Staff Interpretive Letter (Oct. 9, 2003) (*Goldman II*). Specifically, with respect to certain derivatives transactions between an Issuer and a Counterparty, *Goldman II* allows initial hedging transactions made by the Counterparty to be made on a registered basis without requiring all related sales in dynamic hedging transactions (explained below) to be made in keeping with the registration and prospectus delivery requirements of the Act.

The ultimate beneficiaries of *Goldman II* are Issuers that engage in forward transactions, option-based transactions and a combination of forward and option-based transactions with investment banking firms or other Counterparties.<sup>1</sup> The interpretive letter is of most direct benefit to Counterparties that engage in dynamic hedging activities in connection with derivatives transactions entered into with Issuers.

## THE CONTRACTS

The derivatives contracts authorized by *Goldman II* are the following:

- forward contracts, including pre-paid forward contracts and post-paid forward contracts, between an Issuer and a Counterparty
- option-based transactions between an Issuer and a Counterparty (e.g., Issuer purchases put option from or writes call option to Counterparty, or Issuer and Counterparty enter into a transaction involving a combination of options)
- any combination of forward and option-based transactions.

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<sup>1</sup> Counsel's letter suggests that the staff's relief should extend to Counterparties that engage in derivatives transactions with affiliates of Issuers and holders of restricted and Rule 145 securities. The staff did not specifically address this point.

The number of shares (Shares) deliverable pursuant to a Contract would of course vary, and the method of determining the number of Shares deliverable under the Contract would vary, depending upon the terms of the Contract. In any event, the number of Shares deliverable under the Contract would either be fixed, or a method for determining the number of deliverable Shares would be fixed, such that ultimately there would be a maximum number of Shares deliverable pursuant to the Contract (Maximum Number of Shares). The Issuer would never be required to deliver more than the Maximum Number of Shares to the Counterparty in settlement of the Contract. The Contract could also provide for cash settlement or net physical settlement (i.e., delivery of Shares equaling the cash settlement amount).

The Issuer may pledge up to the Maximum Number of Shares to the Counterparty to secure its delivery obligations under the Contract (Pledged Shares). The Counterparty may subsequently borrow or rehypothecate (i.e., pledge while retaining possession) such Pledged Shares. In addition, the Issuer may lend up to the Maximum Number of Shares to the Counterparty (Loaned Shares). Pledged Shares that are borrowed and Loaned Shares would not be returned to the Issuer and re-borrowed during the term of the Contract. The aggregate number of Pledged Shares borrowed from the Issuer or rehypothecated by the Counterparty, Loaned Shares and Shares delivered by the Counterparty upon settlement of the Contract (Settlement Shares) will in no event exceed the Maximum Number of Shares.

## REGISTRATION AND SALE OF THE SHARES

The relief extended by *Goldman II* is available in the case of Issuers eligible to use Form S-3 or F-3 for a primary offering. The Issuer would file a shelf registration statement on Form S-3 or F-3 prior to the time it enters into a Contract. The registration statement would register up to the Maximum Number of Shares deliverable pursuant to the Contract. The Counterparty would be deemed an underwriter of the Shares, and it would be necessary to identify it as such in the prospectus or in a prospectus supplement. The “plan of distribution” section of the prospectus would disclose that the Issuer may sell securities pursuant to a Contract and that the Counterparty may sell securities covered by the prospectus, including in hedging transactions.<sup>2</sup> The Issuer and Counterparty would face potential liability under Section 11 of the Securities Act for sales up to the Maximum Number of Shares.

## INITIAL HEDGING TRANSACTIONS

After the registration statement has been declared effective, the Issuer and Counterparty would enter into the Contract, and the Counterparty would hedge its position by executing sales of up to the Maximum Number of Shares. The Counterparty would be deemed an underwriter of such Shares and would deliver a prospectus in connection with sales of the Maximum Number of Shares. The Counterparty would also purchase in the market such number of Shares as appropriate to bring its short position to its desired initial hedging level.<sup>3</sup>

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<sup>2</sup> This disclosure has become commonplace in shelf registration statements filed under the Act.

<sup>3</sup> In a Contract priced on a “block” basis, pricing of the transaction between the Issuer and the Counterparty is based on a fixed price and not upon prices of any of the hedging transactions carried out by the Counterparty. If a Contract is priced on an “agency” basis, pricing of the Shares in the transactions between the Issuer and Counterparty would be based in part upon initial sales of Shares by the Counterparty.

## DYNAMIC HEDGING

After the Counterparty sells the Maximum Number of Shares in hedging transactions, it may make further sales and purchases in dynamic hedging transactions<sup>4</sup> to bring its position to the desired level. The Counterparty would conduct these dynamic hedging transactions at its sole discretion. The terms of a Contract would not be based on or affected by prices in these dynamic transactions. Since these transactions do not affect, and are independent of, the Issuer, they would not be viewed as having been made on behalf of the Issuer. Accordingly, these sales by the Counterparty would not be made pursuant to the registration statement, but would be ordinary trading transactions exempt pursuant to Section 4(1) or 4(3) of the Securities Act. No prospectus would be delivered in connection with these transactions.

## SETTLEMENT AND CLOSING-OUT TRANSACTIONS

Contract terms could provide for physical settlement, cash settlement or net physical settlement. The Counterparty would not use Pledged Shares, Loaned Shares or Settlement Shares to settle sales made in unregistered, dynamic hedging transactions. It could, however, use up to the Maximum Number of Shares to settle registered hedging sales. It could also close out open borrowings relating to hedging transactions by delivering to the stock lenders Shares that it otherwise owned or borrowed from third parties or Pledged Shares, Loaned Shares or Settlement Shares. If the Counterparty uses Settlement Shares, Pledged Shares borrowed from the Issuer or rehypothecated, or Loaned Shares to close out open borrowings, it may only do so in an aggregate amount not exceeding the Maximum Number of Shares. The Counterparty may also deliver Shares purchased in the open market in connection with cash settlement or net physical settlement of the Contract to close out open borrowings, but only if the aggregate number of Pledged Shares, Loaned Shares, Settlement Shares and Shares so purchased on the open market does not exceed the Maximum Number of Shares. No prospectus would be delivered in connection with closing out these open borrowings.

## STAFF POSITION

In *Goldman II*, the staff took the position that after the Counterparty has made sales of the Maximum Number of Shares in the initial hedging transactions and delivered prospectuses in connection with such sales, the existence of a Contract will not affect an exemption from registration or prospectus delivery otherwise available to the Counterparty for sales of Shares exceeding the Maximum Number of Shares in connection with its dynamic hedging activities. The number of Shares to be registered in connection with a Contract would be the Maximum Number of Shares, and the Counterparty would be required to deliver current prospectuses only in connection with its hedging transactions corresponding to such Shares. Sales of Shares exceeding the Maximum Number of Shares in connection with dynamic hedging activities would be made pursuant to exemptions provided by Section 4(1) and/or 4(3) of the Securities Act.

A condition of the interpretive letter is that Pledged Shares, Loaned Shares and Settlement Shares are not used to settle any sales made by the Counterparty in the dynamic hedging transactions, i.e., any Counterparty hedging transactions exceeding the Maximum Number of Shares. As indicated above, Pledged Shares borrowed or rehypothecated, Loaned Shares and Settlement Shares may be used to close out open borrowings created in the course of the Counterparty's hedging activities related to the Contract.

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<sup>4</sup> "Dynamic hedging" or "delta hedging" refers to a process whereby a position offsetting a static position in a security or derivatives instrument is adjusted (increased or decreased) in response to changes in the value of the static position in order to preserve a desired ratio.

## CONCLUSION

*Goldman II* facilitates certain derivatives transactions between an Issuer and a Counterparty because it allows initial hedging transactions by the Counterparty to be made on a registered basis without requiring all related sales made in dynamic hedging transactions to be made pursuant to registration. If all related sales by the Counterparty had to be made pursuant to registration and the prospectus delivery requirements, Counterparties would not be able to deliver current prospectuses during Issuer blackout periods. This would create an irreconcilable conflict, since Counterparties could not tolerate such constraints on their hedging activities. (See “Four Firm” comment letter on 7-07-97 (May 22, 1997).) In addition, a requirement that all dynamic hedging activities occur pursuant to registration would require the Issuer to keep the registration statement current at all times, which imposes a burden upon the Issuer, as dynamic hedging activity may occur months or years after the parties enter into the Contract. (See “Four Firm” comment letter, *supra*.)

## GLOSSARY

**Contract:** a derivatives contract (e.g., a pre-paid forward contract or an option-based transaction) entered into between an Issuer and a Counterparty

**Counterparty:** a person or entity (such as an investment banking firm) that is a party to a Contract with an Issuer. The Counterparty engages in hedging transactions to hedge its exposure under the Contract.

**Issuer:** the issuer of the Shares that are the subject of the Contract between the Issuer and the Counterparty

**Loaned Shares:** shares the Issuer loans to the Counterparty at the outset of or from time to time during the term of the Contract

**Maximum Number of Shares:** the maximum number of Shares that are deliverable pursuant to a Contract (e.g., the maximum number of Shares deliverable by the Issuer pursuant to a pre-paid variable forward contract)

**Pledged Shares:** any Shares that the Issuer pledges to the Counterparty to meet its share delivery obligations under the Contract

**Securities Act:** the Securities Act of 1933, as amended

**Settlement Shares:** Shares delivered by the Issuer on settlement of the Contract

**Shares:** the underlying equity securities that are the subject of the Contract between the Issuer and the Counterparty

## CONTACT INFORMATION

If you have any questions or would like to learn more about this topic, please contact the partner who normally represents you, or:

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