HAVING YOUR CAKE AND HEDGING IT, TOO

BY SCOTT WELCH

ILLUSTRATIONS BY MELINDA BECK

For clients with concentrated positions, variable prepaid forwards let them **diversify their portfolios** while retaining **control of their stock**

The market boom of the late '90s made wealthy folk out of those who held large stock positions in their own firms, especially if those firms were tech companies or dot-coms. Most advisers have at least one client who has a substantial holding in his own company, is still bullish on the stock, and, for tax reasons, doesn't want to sell it—but wants to diversify his portfolio. The question then becomes, how?

The traditional answer is to hedge. "We are located in the heart of Silicon Valley," says Richard Baer, a principal of Legacy Capital Group, a Los Altos wealth-management firm, "and many of our clients come to us with low-basis, concentrated stock positions. We are active users of different trust strategies but wanted to expand our ability to help our clients manage their risk. That's where hedging strategies come in."

Still, finding a way to hedge a large holding has never been easy, and to make matters worse, the Taxpayer Relief Act of 1997 amended the guidelines for a "constructive sale"—a transaction that's considered a sale for tax purposes, even if no shares are actually exchanged. As a result, the methods investors had traditionally used to gain liquidity from concentrated equity positions—and, thus, hedge those positions—became ineffective for tax deferral.

But necessity is the mother of invention, and in the wake of the act, Wall Street came up with a new way for investors and their advisers to manage equity risk. The solution was variable prepaid forwards, which deliver what many investors are looking for: protection from a downward spiral in a stock's price, profit from a price increase, deferral of taxes, and liquidity up-front so a client can reinvest in other equities. What's more, a 1999 no-action letter by the Securities and Exchange Commission effectively sanctioned the use of variable prepaid forwards for hedging the stock of insiders and affiliates. The twist is that they are complex transactions, and advisers need to be sure they understand how to set them up so the constructive-sale rules aren't tripped—and the tax-deferral strategy undermined.

Historically, selling short against the box was the preferred technique for gaining liquidity from a large stock holding: an investor could lock in a price for the underlying stock and borrow up to 95 percent of the locked-in value for reinvestment. But the short-against-the-box transaction was specifically targeted by the Taxpayer Relief Act of 1997 as a constructive sale. The act didn't affect equity collars, another favored hedging technique. Collars remain a viable alternative for protecting a stock's price. But collars have drawbacks when it comes to borrowing against them to diversify a portfolio. Any borrowing done against a collared stock position is subject to restrictions that limit the amount of money the banks can lend if the investor wants to reinvest in equities; specifically, the banks can lend a maximum of 50 percent of the market value of the stock—known as a purpose loan (see "A New Leash on Loss," May 2000).

But what about a client who wants to reinvest more than 50 percent? With the short-against-the-box strategy no longer feasible, investment banks created another: the variable prepaid forward (VPF), variously known by catchy acronyms like MMAPs, STARS, STAMPS, and TRACES, which different banks use to brand the product. A variable prepaid forward isn't a loan; it's a sale of a contingent number of shares, which will be delivered at some future date, in exchange for a cash advance today—much like public-market debt exchangeable for common stock, only negotiated privately for an individual client. But the number of shares—and thus their exact cash value—isn't determined until maturity, based on the stock's price at that time (see "Sweet Recipes," page 63). It's that uncertainty that keeps these transactions from tripping the constructive-sale rules—and allows your client to delay paying taxes while hedging his equity position. The downside protection stems from the fact that if the stock price crashes, the investor loses only the shares pledged and nothing more.

Because they're individually negotiated, variable prepaid forwards can be structured in various ways. For example, to maximize the amount of money an investor gets up front, the VPF can be structured as a 100 to 120 percent contract with no gains above the ceiling price. The investor agrees to forgo enough of the stock price's increase, or the upside, to avoid a constructive sale—usually considered to be at least a 20-percentage-point difference between the put and call strike prices, though it's never been codified into formal regulation; and depending on the maturity of the trade and the stock being hedged, he may generate 85 to 90 percent of the market value of the stock as a cash advance. This strategy works well for a client who's inclined to sell the shares anyway. By using the VPF rather than an outright sale, he generates more money up front than he would in after-tax proceeds of a sale, defers the payment of capital-gains tax for at least the life of the contract, and doesn't lock himself into the sell decision, because at maturity he can make a cash settlement and keep his shares or roll them into a new trade.

On the other hand, many clients want to use the forward to create a balance between protection against a downward price slide, retention of growth, and the cash advance. To achieve equilibrium among these three factors, a bank might set the floor and ceiling prices to look like a zero-premium collar, say, 90 percent to 175 percent. This strategy allows the investor to keep far more upside on a stock position; depending on the maturity of the trade, however, he may only receive 65 to 75 percent of the stock's market value.

Though this cash advance is less than what an investor could expect if he took less upside on the stock, it's greater than the 50 percent maximum amount he could borrow against a stock collar. In the traditional equity collar, any loan taken out against the protected stock position is considered a margin loan for regulatory purposes, even though the investor would probably never face a margin call, because the stock has a guaranteed minimum value. A VPF, on the other hand, is not a loan against the stock but an actual sale of the underlying security, albeit with a future delivery date. So most tax professionals believe that margin-lending restrictions do not apply to VPF transactions.

Another advantage VPFs have over stock collars concerns the financing cost associated with each transaction. With a traditional collar-and-loan strategy, the interest rate—the cost of borrowing against a collar—is floating, subjecting the investor to interest-rate risk, and is accrued and paid periodically over the life of the transaction. With a VPF, the difference between the current market value of the stock and the actual cash advance received represents the financing cost of the transaction. This discount is fixed

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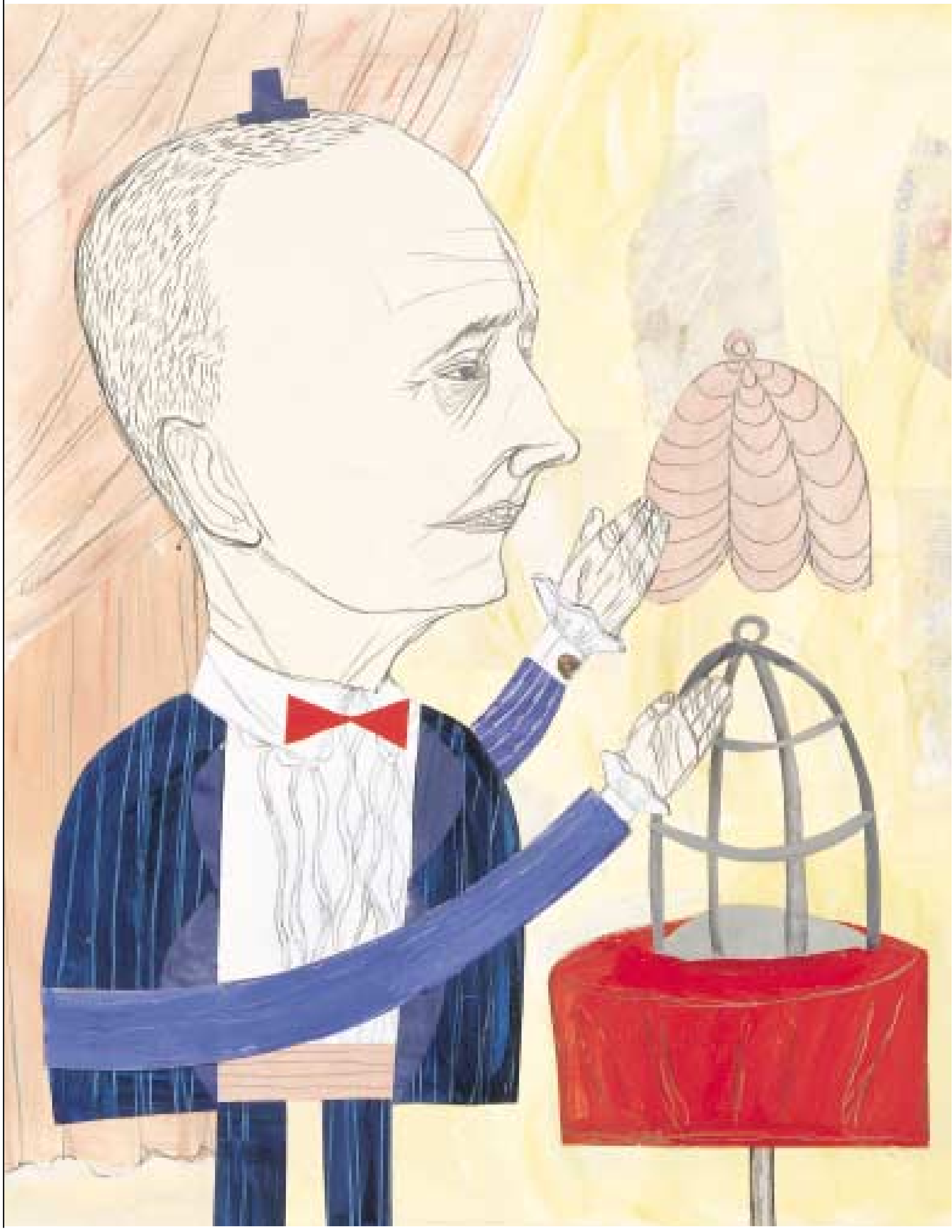
on the date of the transaction, so investors don't face the risk of rates rising over the life of the transaction as they would with a floating-rate loan taken against a collar. Further, with a collar, because the interest expense is paid periodically over the life of the trade, this creates a drag against income from the portfolio. A VPF doesn't create this drain, because the only cash flows involved are the initial cash advance and the final repayment.

The poor performance of the equity market in 2000, although it probably hurt investors who had already hedged, created yet another useful application for VPFs. During the soaring market of the 1990s, many investors financed expenditures by taking out margin loans against their concentrated stock positions. As long as the market continued to surge, this was a viable cost- and tax-effective way of generating liquidity without selling shares. But since the stock market began falling, these investors have been hit by a double whammy. As the value of their stock has fallen below legal limits relative to their outstanding loans, they have faced margin calls. In many cases, investors have been forced to sell stock in a declining market to pay off those margin calls. This puts downward pressure on the stock, which triggers still more margin calls, in turn causing more stock sales.



The VPF helps investors break this downward cycle by using the proceeds of their forwards to pay off outstanding margin loans, in effect putting a limit on further declines in the price of the stock holding and removing the cash drain of margin calls and ongoing interest expense. One of the most publicized examples of using a VPF to staunch the bloodletting involved Bernard Ebbers, president and chief executive officer of WorldCom. In November *The Wall Street Journal* reported that Ebbers had entered into a VPF on about 3 million shares of WorldCom, using the $70.6 million in proceeds to repay outstanding margin loans—and prevent any further decline in the value of his stock.

In addition to the economic benefits of VPF transactions, there are potential regulatory benefits as well, especially when your client is dealing with either insider or affiliate shares. The definition of *affiliate* is broad; it includes the officers of a corporation and the spouses and relatives who live with them, anyone in a position of influence over an officer, and anyone who owns at least 10 percent of the outstanding shares of a corpora-

SWEET RECIPES

A **VARIABLE PREPAID** forward isn't so hard to understand as long as you remember that it's not a loan but a cash advance against a forward sale of securities. Take the hypothetical example of an investor, whom we'll call Joan, who holds $10 million in stock XYZ. Joan is still bullish on XYZ but recognizes that this position represents too high a percentage of her net worth. Because she doesn't want to incur capital-gains tax and still believes in the company, she doesn't want to sell the stock. But she wants to generate liquidity she can use to reinvest in other equities, creating a more diversified portfolio and protecting herself from a downward price movement.

Let's say Joan's position is one of 400,000 shares with a current market price of $25 and a basis of $0. The maturity date for VPFs is flexible and typically ranges from two to 10 years, with three to five being the most common. So assume Joan opts for a three-year contract. She structures the VPF with Bank A with a minimum price-per-share value of 100 percent ($25 per share), maximum price-per-share value of 125 percent ($31.25 per share), growth beyond the ceiling price retained by the investor at 20 percent, and a cash advance of 80 percent of the current market value ($8 million).

Essentially, Joan has agreed to sell a certain number of shares to Bank A, but she will not deliver those shares for three years, and the number of shares she will deliver will depend on the stock price at that time. In exchange, Bank A pays her $8 million today and will ask for $10 million—or more, depending on the stock's price—at maturity. Because of the uncertainty in the number of shares she will actually deliver at maturity, most tax attorneys agree that there is no taxable event on the date of the transaction, so the investor has generated liquidity from the position while not actually selling her shares for tax purposes.

Joan is fully protected below the current market price, less the implied financing cost of the trade, over the three-year life of the forward. She'll keep any growth in the stock up to $31.25 and 20 percent of any growth above that figure. And she'll receive $8 million up front that she can reinvest with no restrictions. In exchange, she'll be required to deliver $10 million, if a cash settlement—or an equivalent number of shares, called a physical settlement—at maturity, plus the cash or stock equivalent of 80 percent of any price increase in XYZ above $31.25.

It's at this point that the protection a variable prepaid forward offers becomes clear: If the price of XYZ is below $25 at the end of the three years, Joan can settle the trade by delivering all of her shares to Bank A—even though the market value of those shares is below $10 million. If the price of XYZ happens to end up at $31.25 (125 percent of the initial price), she can settle the trade by delivering only 80 percent of her shares: $31.25 per share times 320,000 shares equals $10 million. Because she retains 20 percent of any growth in the stock above $31.25, once the price of XYZ reaches $31.25 or higher, she can settle by delivering exactly 80 percent of her stock. If the price of XYZ ends up somewhere between $25 and $31.25, she can settle the trade by delivering the number of shares necessary to generate $10 million. For example, if the stock price ended up at $30, the investor could settle by delivering 83.33 percent, or 333,333, of her shares: 333,333 shares times $30 per share is approximately $10 million.

What are the tax consequences of these transactions? The tax treatment of the settlement of VPFs depends on whether the transaction is a cash or physical settlement. If it's the latter, what's important is how much money the investor received up front—think of it as the selling price of the transaction. The question is how many shares the investor's selling price will be applied to. In the above example, if Joan closes the trade with a physical settlement, she received $8 million up front, so this is her selling price for tax purposes. If the stock price falls below $25 and she delivers all of her shares upon settlement, then for tax purposes she will have sold 400,000 shares for a total of $8 million, and her tax will be based on the difference between her basis and $8 million. If the price of XYZ is higher than $25 at maturity, her selling price for tax purposes remains $8 million, but this amount will be applied to fewer shares—however many she delivered to settle the trade. She retains ownership of the shares she does not deliver and will owe no taxes until she actually sells those shares.

It's important to remember that VPFs, like collars, are considered "tax straddles" under Section 1092 of the Internal Revenue Code, so the tax treatment can be very complex. You should always retain a tax specialist to review the transaction before entering into it. *—SW*

tion, whether or not he has a formal relationship with it. Affiliate and insider shares are subject to the same trading rules. If an investor designated as an affiliate or insider engages in a purchase and sale of stock within a six-month time frame, there's a risk that the investor may trigger what the SEC refers to as a "short-swing profit disgorgement," in which case the investor may then have to "disgorge" any profit from those transactions back to the issuer. Equity collars can place the investor at greater risk of tripping the short-swing profit rules, and many

THE RIGHT MIX

Given the complexity of variable prepaid forwards, you need to be sure they're the right match for a client. The VPF can be a wise choice for those who want to maximize the amount of money taken out of a trade to reinvest in a more diversified equity portfolio—for instance, someone who's inherited a low-basis position through a wealth transfer and seeks broader diversification or, conversely, an elderly client looking to protect the value of an appreciated stock position prior to having an heir realize a step-up in basis upon inheriting the position.

But if an investor is bearish on the stock, using a VPF strategy may not be appropriate, because she incurs a financing cost for an asset that may depreciate in value. In such a situation, advisers may want to consider tax-effective selling strategies, like charitable remainder trusts or donor-advised funds. Also, because it's highly regulated, a VPF may not be appropriate for less-sophisticated investors, for those with a net worth of less than $5 million, or for those whose stock position represents the overwhelming percentage of their overall net worth. Further, not all stocks can be hedged effectively or efficiently. It may be difficult to hedge stocks with low market capitalization, low trading volumes, or a severely depressed stock price.

And if the stock price goes down after hedging, the VPF may end up being an expensive solution. William Baldwin of Pillar Financial Advisors in Waltham, Mass., tells of a client in such a situation. "I had a client who sold his company in exchange for another's publicly traded stock," Baldwin says. "When the pooling period ended, he sold 50 percent of the stock and entered into a VPF contract on 30 percent of his position, worth just under $3 million. The rest he kept to sell gradually. The stock fell sharply. In about two years he faces a large tax liability on the VPF contract. Will he remember the up-front benefit? Will the 15 percent haircut he took to get the tax-free cash now be worth it to him—especially when last year's dismal stock market performance means he might not earn it back by then?"

In addition to deciding whether a client is right for a VPF, you also need to settle on the appropriate bank or specialist. It's unlikely that the same bank will offer the best terms and conditions on every transaction, so advisers should cultivate relationships with several, focusing on the following criteria:

- The credit rating of the firm and its specific experience in conducting variable-forward transactions
- Competitive pricing combined with the flexibility to customize solutions based on the client's specific situation. There is almost always some sort of twist to any given transaction, such as the client's holding restricted shares, being an affiliate, or having the shares held in a trust or partnership.
- A willingness to negotiate the terms of the contract to create a more equitable relationship between the client and the counterparty bank

As an alternative, you can establish a partnership with a third-party risk-management specialist who assumes the responsibility for structuring, pricing, documenting, and executing the transaction. "We have been involved in enough transactions to be comfortable with the economics and overall tax issues of the strategies," says Richard Baer, a principal of Legacy Capital Group in Los Altos, Calif. "But these can be complex deals, so we work with an objective, third-party specialist to make sure our clients are getting the best possible pricing and documentation."

Baldwin agrees. "I have degrees in accounting and law, and a master's of law in taxation," he says. "I've drafted insurance contracts, bond indentures, and tax opinion letters. It took me 10 hours to really understand the VPF contract and additional time to bid it out to another firm to compare the terms. A specialist would have been a bargain." —*SW*

investors steered away from these transactions as a result.

But on December 20, 1999, the SEC, in response to an inquiry from Goldman Sachs & Co., issued a no-action letter addressing the use of VPFs as a means of hedging affiliate stock. Although the letter didn't eliminate any of the insider-trading restrictions, financial professionals widely interpreted it as effectively laying out a template by which banks and investors can work together to hedge affiliate stock using a VPF transaction. What this means for an investor is that, from a regulatory perspective, the date of sale for her shares is the date the VPF transaction is entered into—making it easier to manage the insider-trading issues—whereas the date of sale for tax purposes remains the maturity date of the VPF, deferring the taxes associated with selling. In addition, the counterparty bank that takes the investor's shares in as collateral for the VPF transaction can then have the shares "cleansed"—in other words, the legends and restrictions are removed—so that the shares become freely tradable. This increases flexibility for both the investor and the counterparty bank and facilitates a physical settlement of the transaction at maturity.

The SEC's no-action letter is not a panacea. As an affiliate, an investor is still subject to other insider-trading restrictions, and she's still required to file all necessary

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disclosures with the SEC; and the letter does nothing to address any internal corporate policies regarding hedging, such as trading windows or blackout periods. The no-action letter also doesn't remove the short-swing profit-disgorgement risk. But by fixing the regulatory date of sale of stock as the transaction date of the VPF, this risk becomes easier to manage for the investor and her adviser.

VPFs, and especially their applications for affiliates, can be highly complex, and you should always work with tax and financial professionals who have experience with these transactions, such as independent specialists or the risk-management groups at banks (see "The Right Mix," page 64). Experts can help you avoid mistakes that could void the entire transaction, mistakes like structuring the trade without enough uncertainty to avoid being called a constructive sale, not adequately documenting the transaction to show that the trade isn't a loan against collateralized stock but rather a forward sale of securities, or not negotiating with the counterparty bank on the particular terms of a contract.

Still, despite the extra effort they require, VPFs are a valuable addition to the range of options advisers can offer wealthy clients as part of an overall strategy to protect their assets. "We rarely use the variable-forward trade as a standalone transaction," says Brent Bunger, principal at Legacy Capital Group. "We use it as an important step in a more comprehensive overall wealth-management plan. We have developed some very creative investment- and tax-management strategies for high-net-worth clients, and the variable prepaid forward frequently is the transaction that allows us to unlock the liquidity in a low-basis position"—the liquidity that helps put the rest of the overall plan into action.

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■ **The idea of a constructive sale was first established by the Taxpayer Relief Act of 1997.** ***A. True B. False***

■ **Which one of the following is not part of a variable-prepaid-forward contract?** ***A. The investor agrees to sell a certain number of shares to the bank. B. The investor delivers those shares to the bank up front. C. The number of shares the investor delivers depends on the stock price at the time of delivery. D. The bank pays the investor a cash advance of a certain percentage of the current market value of the shares.***