
EQUITY DERIVATIVES

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I. Background

A derivative security is a financial contract entered into with respect to an underlying security whose value is derived from the potential changes in the value of the underlying asset. Examples of derivative securities vary and include put and call options, futures contracts, warrants and convertible or exchangeable instruments (whether optional or mandatory). The security underlying a derivative security can vary as well, and the underlying asset can be an equity security, a treasury bill, foreign currency, or even another derivative security. The issuance of an equity derivative (or a derivative security whose value is based on the value of an underlying equity security) can offer tax and other financing advantages over the more traditional capital-raising methods of equity issuance and debt financing. This outline will focus on strategic, legal and logistical factors that must be considered by a company contemplating the issuance of an equity derivative security. Case studies of equity derivative securities offerings will be discussed to illustrate how these instruments are being used to provide strategic financing options, both for issuers using equity derivatives tied to their own equity securities and for issuers creating equity derivatives whose value is dependent on underlying equity securities of other companies.

II. Options/Warrants

A. Options

Calls and puts are the two basic types of options and are the building blocks around which more complex instruments are frequently constructed. Call options give the holder of the option the right to buy a security (and the “writer” of the option the corresponding obligation to sell upon exercise), typically at a fixed or formula-determined price. Put options give the holder of the option the right to require the “writer” to purchase the underlying security, typically at a fixed or formula-determined price. Options and warrants can be American, European or quasi-American. An American option can be exercised at any time during the term of the option, a quasi-American option can be exercised on specified dates, and a European option can only be exercised on the maturity date of the option.

B. Warrants

1. A warrant entitles its holder to purchase from the issuer shares of underlying equity (most often common stock) at a pre-determined price. Most often, warrants are attached to preferred stock or debt securities of the issuer as a unit for sale to investors. Call options and warrants are very similar, with warrants historically lasting longer than call options, with a life span generally ranging from three to five years. The exercise or “strike” price of a warrant is typically higher than the market price of the underlying equity security at the time of issuance of the warrant, generally 20% or more. The terms of some warrants may specify a range of exercise prices (e.g., an exercise price that increases over time) or may permit the holder to pay the exercise price for the warrant through the delivery of another security at the time of exercise.

2. Warrants can be issued to purchasers in conjunction with an offering of common stock or debt securities to improve the attractiveness of an offering. Warrants

can either be detachable (either immediately or after a pre-determined period of time when the warrants may separately trade) or attached or “stapled” to the other securities issued in conjunction with the warrants.

3. When warrants are issued in a unit with debt securities, the terms of the warrants may permit the holder to pay the exercise price of the warrants with the associated debt securities. Debt securities issued with warrants synthetically replicate convertible debt and offer benefits to both the investor and the issuer. The investor may separate the warrant from the host bond and realize the value of the call option imbedded in the warrant while retaining its investment in the associated debt security of the issuer. The issuer enjoys tax and accounting benefits - for example the fair market value of a warrant is recorded as equity so in calculating earnings per share, the issuer can use tracking stock, rather than “if converted” method of accounting for the dilutive effect of the issuance of the warrant. In addition, the issuer of a unit (as opposed to a convertible note) may benefit from incremental tax deductions arising as a consequence of amortizing as “original issue discount” (OID), over the term of the host bond, the value allocated to the warrant as of the issue date of the investment unit, with the Issuer’s OID deduction being matched by the accrual of OID income by taxable holders of the host bonds.

4. Warrants will typically contain protections against dilutive issuances such as stock dividends and stock splits and other corporate reorganizations and recapitalizations. The purpose of these provisions is to permit the holder to remain in essentially the same position following such an event as if the holder held shares of the issuer's common stock (as opposed to the warrants) prior to the occurrence of such event. Less common is “price” anti-dilution protection, which would result in the reduction in the exercise price of the warrants and/or an increase in the number of underlying shares issuable upon exercise of the warrant in the event of issuances of shares of the underlying equity or securities convertible into shares of the underlying equity at a price lower than the exercise price (or the market price at the time of issuance of the warrants).

C. Options Exchanges

Generally options written by issuers are traded on exchanges while options written by third parties are traded over the counter. Options contracts traded on an ordinary exchange are standardized as to the exercise prices available, the maturity dates, the number of units of the asset that can be purchased or sold per option contract and the procedures dealing with stock splits and dividends. When options are listed on an exchange, common stock rules apply and settlement must be made five days from the trade date.

D. Strategic Concerns for Issuances of Warrants

1. As a capital-raising tool, the use of warrants enables an issuer to reduce the dilution associated with a sale of its common equity securities by fixing the exercise price at a premium to the market price of its common equity securities at the time of issuance of the warrants. Attaching warrants to an offering of equity or debt securities is often used to “jump start” an offering that might not otherwise be feasible on the

contemplated terms. In addition, warrants are often used to improve the terms of an offering of the issuer's debt securities, as the value of the attached warrants typically results in a lower interest rate on the associated debt. Issuances of warrants are frequently associated with startup ventures and companies with non-investment grade debt ratings.

2. Threshold questions a company contemplating the issuance of warrants must consider are its present and future capital needs, the cost of capital, the issuer's overall corporate capital structure and ability to sell the warrant at a fair value given an acceptable exercise price to the company. Factors for the issuer to keep in mind when engaging in such analysis include the following:

(a) Warrants are designed to lower the cost of capital (whether for the associated debt or equity securities) on the issue date, so in analyzing whether issuance of warrants is worthwhile, the issuer must analyze the current market conditions and attempt to predict future market conditions for both its debt and equity securities.

(b) The exercise of warrants will still be dilutive of per share earnings, cash dividends and voting power of existing shareholders, although the issuance of warrants with a strike price in excess of the current market price of the issuer's common equity securities will be less dilutive than an offering of equity securities which often results in temporary downward pressure on the market price.

(c) The dividend or coupon interest payment should be lower than that for an identically structured security that has no warrant. The issuer must decide if the initial savings on debt service costs justifies potential future equity dilution associated with the warrant exercise.

3. Another advantage to the issuance of warrants is that they can reduce price volatility of the issuer's stock because professional investors use them as a hedging technique. Warrants can also be used to meet other corporate purposes such as dividends or shareholder rights, as additional value in mergers, acquisitions or reorganizations, or as additional compensation to underwriters.

4. For most publicly traded issuers, the issuance of warrants, especially detachable warrants, will result in additional costs of administering an additional class of publicly traded equity securities.

E. Regulatory Framework for Issuance of Warrants and Options

The SEC and NASD traditionally are not as restrictive with respect to the issuance of warrants as they are about options (which require a seller to understand the purchaser's investing experience and to disclose risks of investing in options). Warrants are typically offered much like any other securities with their terms specified in a prospectus specifying the exercise price, whether the buyer will receive a physical or cash settlement, the final exercise date, whether the warrants are American or European, how the exercise price is to

be paid, the call features, the effects of subsequent dilutive acts on the underlying shares and the ability of the issuing corporation to change any of the listed terms.

The exercise of a warrant is a cash exchange. As a result, when the exercise takes place the issuer must deliver to the holder a prospectus meeting the requirements of Section 10(a) of the 1933 Act. As a result, an issuer of a warrant must keep its prospectus current with respect to the underlying stock to ensure it is able to honor exercises without violating the 1933 Act.

III. Convertible Instruments

Traditional convertible instruments are debt securities or preferred stock convertible at the holder's election into the corporation's common stock at a conversion price above the market price prevailing at the time the security is offered. Convertibles generally take on one of two forms - convertible bonds or convertible preferred stock. An issuer may also create debt or equity instruments that are exchangeable for the equity securities of other issuers (whether affiliated or unaffiliated) in which the issuer holds an investment. There is also an endless variety of hybrid instruments that mix the essential characteristics of both debt and equity securities in order to achieve the issuer's particular objectives. A separate category of equity derivative securities, loosely defined as a "mandatory" requires the holder at some point at or prior to the maturity of the instrument to convert or exchange the instrument for the underlying equity securities (or the cash value thereof). While the variety of "mandatory" structures is near infinite, the holder generally is dependent on the value of the underlying equity security (as well as any interim coupon payments provided for in the terms of such securities) in order to achieve a return on its investment.

A. Convertible Bonds

1. General.

Convertible bonds are convertible subordinated debentures that generally are junior to most other corporate debt. They represent a fixed income obligation of a company. They typically provide for a periodic coupon payment to holders (although they can be issued on a zero coupon basis) and always obligate the issuer to return the principal amount of its borrowings (the face value) to the holder at a specified redemption date. They tend to be long-term instruments with maturities of up to 30 years, but they may provide for mandatory annual sinking fund payments designed to retire a specified percentage of the issue prior to maturity.

2. Zero Coupon Convertible Bonds.

Zero coupon convertible bonds do not provide for regular coupon payments but effectively provide for a specified return on the underlying fixed obligation by being issued at a discount from their fixed value at maturity. While regular interest payments are not made, some zero coupon convertibles provide for payments of contingent interest in the event that the share price of the issuer's common stock appreciates significantly and the issuer has made payments of dividends to its shareholders. The redemption date is usually 20 to 25 years from the date of issuance. Zero coupon convertible bonds are usually convertible into a fixed number of shares of common stock prior to the maturity date. The terms of issuance may permit the holder to call for

a repurchase of the bonds at a specified price on specified dates or permit the issuer to call for a redemption of the bonds on or after a specified date.

3. Market Trends for Zero Convertible Bonds.

There has been a notable surge in the number of issuances of zero coupon bonds during the last two years. Only a handful of such issuances were made each year during the period from 1990 to 1997. In 2000, an unprecedented 23 issuances were made. As of October 3, the number of such issuances has more than doubled in 2001 with a total of 52. 80 of the 113 known issuances of new coupon convertible bonds have been in excess of \$500,000,000. 28 of the remaining issuances have been in the \$250,000,000 to \$500,000,000 range. The remaining five such issuances have been for less than \$250,000,000. The ratings on zero coupon convertible bonds vary widely, with 25 of the 113 known such issuances receiving Standard & Poor's ratings of A- or better, and 23 receiving Moody's rating of A3 or better. 41 of the 113 such issuances received Standard & Poor's ratings in the BBB- to BBB range. 45 received Moody's ratings in the Baa3 to Baa1 range. The vast majority (91 of 113) of zero coupon convertible bonds have been registered under the Securities Act of 1933.

B. Convertible Preferred Stock

1. General.

Convertible preferred stock is usually senior only to common stock with respect to rights to dividends and upon liquidation. The issuer of a convertible preferred stock typically pays a fixed dividend, usually on a quarterly basis for as long as the security exists. Dividends may be paid in cash, shares of the issuer's common stock or in additional shares of the convertible preferred stock. Convertible preferred may not have a set redemption date, in which case the conversion right will continue indefinitely (although the issuer may retain the right to call the security in the future). In the alternative, convertible preferred may be redeemable only during a specified time period, typically beginning two to three years after the date of issuance and terminating on a set expiration date. Most recent issuances of convertible preferred have had a set redemption date. At any redemption, the issuer agrees to pay the holders a redemption premium equal to a set redemption price plus accumulated and unpaid dividends. The dividend rate, as well as the conversion price, of a convertible preferred stock will be determined at the time it is offered for sale and will largely depend on "market" terms for similar issuances. The conversion price is usually fixed at a price ranging from 15% to 25% over the market price of the issuer's common stock at the time of initial issuance, enabling the issuer to issue its stock at a premium over market.

Occasionally convertibles will be issued that provide for a "step-up" or increase in the conversion price at stated intervals over the security's life. Convertibles may also include downside protection for the holder which can take the form of a reset feature that will reduce the conversion price upon declines in the market price of the underlying security. The conversion price is generally also subject to adjustment to reflect stock splits, stock dividends and distributions of rights and warrants permitting holders to purchase common stock at below-market prices. Less common is "price weighted antidilution" protection which is customary in the case of a convertible preferred issued by a private company in a venture capital context.

Holders of convertible preferred stock generally are not entitled to voting rights. However, some issuers entitle holders of convertible preferred shares to elect a certain percentage of the issuer's board members upon the occurrence of certain events, like the issuer's failure to pay dividends over an extended period.

2. Market Trends for Convertible Stock.

Prior to 1991, only six public issuances of convertible preferred stock had been made. During the early 1990's these issuances became more frequent with anywhere from five to fourteen issuances per year. In 1996, the number of issuances quadrupled over the previous year, with a total of 22. During subsequent years, up until 2000, convertible preferred stock issuances continued at comparable rates peaking with 37 in 1998. Issuances of these securities have tapered off in 2001 with only five made through October 2, 2001. The size for most convertible preferred stock offerings have hovered between \$100 million and \$500 million. Of 177 known offerings of convertible preferred stock, 119 have been in this size range. 32 issuances have been for more than \$500 million and 26 have been for less than \$100 million. Most convertible preferred stocks do not enjoy high ratings. To date only one has received an A1 rating from Moody's and two have received an A rating from Standard & Poors. Moody's ratings for most convertible preferred stocks range from B2 to caa while Standard & Poors ratings for most range from B+ to BBB-.

C. Mandatory Convertibles

1. General.

Mandatorily convertible securities eventually convert to common stock (or the cash equivalent value of the underlying common stock) regardless of the price performance of the security itself (or the underlying common stock) or the preference of the holder. The conversion is triggered either when the price exceeds a certain level or by the passage of a specified period of time. An issuer may create mandatorily convertible instruments using its own common stock as the underlying common equity security as a means to increase the effective price at which it is issuing its common equity or may utilize portfolio securities of other issuers as a means to realize on prior investment by the issuer in the securities of the issuer of such other securities (and often to defer the recognition of the gain that would accompany a sale of the underlying securities). Generally, a purchaser of a mandatorily convertible security will expect a higher interim coupon payment than a purchaser of a traditional convertible instrument. The terms of a mandatorily convertible instrument generally provide that the holder is entitled to receive at maturity of the instrument the cash value of the underlying shares of common stock (or a specified fraction of the underlying securities depending on the market price of the underlying security at maturity). Indicative terms for an offering of a mandatorily convertible instrument (based on a then market price for the issuer's common stock of \$50) might include a \$50 issue price with an aggregate annual coupon of between \$2.50 and \$4.00 (i.e. 5-8% per annum), and terms that provide that at maturity (either 3 or 5 years from the date of issuance), the holder would be entitled to receive (i) one share of the underlying common stock (or the cash value thereof), if the market price of the common stock at maturity is less than \$50, (ii) between 1 share and .8 of a share, if the market price of the underlying common stock is between \$50 and

\$60 (i.e., 120% of the market price at the time of issuance), and (iii) .8 of a share, if the market price of the underlying common stock at maturity is in excess of \$60.

2. Market Trends for Mandatory Convertibles.

Issuance of mandatory convertibles first occurred with a single offering in 1996. The next activity in this market was in 1998, with four issuances. Issuance activity peaked in 1999 with 18 and then tapered with seven issuances in 2000 and nine completed in the first nine months of 2001. A total of 40 such issuances have been made since 1996, with the majority involving gross proceeds of \$250,000,000 or more. They have not enjoyed particularly high ratings, with the majority of such securities receiving a Moody's rating between Baa3-Baa1 and Standard & Poors rating between BBB- and BBB. All but one such issuance has been made in a registered offering.

D. Strategic Concerns for Issuances of Convertibles

1. Financial Concerns

Raising money through the use of convertible instruments has certain apparent advantages since it enables the issuer to issue its common stock at a higher effective price and convertible instruments generally pay a lower coupon than traditional fixed income obligations. However, an issuer must also consider that if the underlying share price rises such that conversion takes place (in the case of an instrument that is convertible at the option of the holder), the cost of the financing to the issuer might actually be greater than if it had issued straight debt (when taking into account the ultimate value of the underlying equity delivered upon conversion of the convertible instrument). In the alternative, if conversion does not take place (or in the case of a mandatorily convertible instrument, if the market price of the underlying common stock declines), the issuer might be better off had it issued pure equity (especially when taking into account the coupon payments made by the issuer during the term of the convertible instrument). To properly analyze whether engaging in convertible financing is worthwhile (and the ideal structure for any such convertible instrument), an issuer essentially needs to make a bet as to its future stock price (at least during the term of the convertible instrument in question). If the future is uncertain, the issuer would be well-served to use convertibles as part of a financing portfolio. Convertible financing offers the best value to an issuer if, during the period in question, its share price grows by a percentage that is less than the interest rate the company would have had to pay to borrow money (or the net present value of the coupon payments on a mandatorily convertible instrument). Some issuers have capped the potential downside resulting from unexpected gains in the price of their common stock by making the convertible units mandatorily convertible if the trading price of the underlying common stock exceeds the conversion price by a certain percentage within a certain time frame. Conversions of zero coupon convertible bonds can be restricted if the conversion value of the bond is greater than or equal to a specified percentage of the bond's issue price. The most common convertibility feature provides for a fixed conversion price through the maturity date.

2. Qualitative Concerns

(a) The issuance of a convertible instrument (depending on its structure) can send a positive signal to equity markets by suggesting that the issuer expects share prices to go up.

(b) The issuance of a convertible instrument can also enable an issuer to broaden the market for its securities since the issuance of a security with a higher income and different capital risk/reward profile may appeal to investors who would not invest in the issuer's common stock or debt (in particular to funds that invest principally in convertible instruments).

(c) Issuers with limited access to debt markets due to low credit ratings may have better access to the convertible market, which is less risk-averse due to the potential for equity-like returns from most convertible instruments.

3. Tax Advantages

Dividends on convertible preferred stock are not deductible by the issuer (other than special entities such as REITs) and, therefore, must be paid with after-tax income. By contrast, the interest or original issue discount that accrues on convertible debt is generally deductible until the debt is converted, unless the debt instrument is considered to be “payable in equity” under Section 163(l) of the Internal Revenue Code or another exception to deductibility applies.

In general, debt that is convertible into equity solely at the holder’s option is not subject to Section 163(l) unless there is a “substantial certainty” on the issue date that the holder will eventually exercise its conversion rights. Mandatorily convertible debt, however, is subject to Section 163(l), which applies if (i) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, equity of the issuer or a related party; (ii) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity; or (iii) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in clause (i) or (ii). Investment banks and their tax advisors have created various financial instruments designed to replicate the benefits of mandatorily convertible debt without being subject to Section 163(l). Typically, these financial instruments involve the sale of an investment unit consisting of a forward contract to purchase the issuer’s stock and straight debt of the issuer having a longer term than the forward contract. The debt instrument is pledged to the issuer to secure the holder’s obligation under the forward contract, but the holder may release the debt from the pledge by substituting Treasuries that mature on the forward contract settlement date. Holders who do not substitute Treasuries are expected to settle their obligations under the forward contracts with the proceeds of a remarketing of the debt, with the issuer agreeing to reset the interest rate on the debt in order to ensure a successful remarketing.

4. Accounting and Rating Considerations

Even though the interest or OID on convertible debt is generally tax deductible to the issuer while the dividends on convertible preferred are not, convertible preferred still may offer advantages to the issuer. Most importantly, convertible preferred is equity while convertible debt remains debt unless and until it is converted or exchanged for the underlying common equity. Rating agencies will also view convertible preferred more favorably than debt obligations to the extent that there is no fixed maturity or right on the part of the holder to declare a meaningful default in the event the issuer fails to make any required payments of dividends or on maturity. Depending on the terms of the underlying instruments, convertible preferred and the related dividend payments also will likely be disregarded for purposes of determining compliance with the issuer's total debt and interest coverage tests in bank debt and indenture covenant packages.

5. Call Features

A call feature allows an issuer to redeem a convertible security before its stated maturity at a predetermined price. An issuer will generally exercise this feature when the value of the bond without the call feature (or the effective cost to the issuer to replace the convertible security with a different type of financing taking into account the difference in terms) is less than or equal the cost to the issuer to call the existing convertible security. Upon exercise of an issuer's call right, the holder of the convertible security is typically faced with the choice of receiving the call price or converting the security and receiving the underlying common equity securities. The inclusion of a call right in a convertible security gives some level of comfort to an issuer that investors ultimately will elect to convert the convertible instrument into common equity (and allow the issuer to cease making coupon payments on the convertible instrument). However, the issuer has no such protection to the extent that the future market price does not trade above the strike price on the convertible instrument at a time when the convertible security is callable. By timing the exercise of the call right at a time when the market value of the shares into which the convertible can be converted is above the call price, the issuer can convince most investors to choose equity over cash. Including a call right also imposes costs on the issuer of the convertible instrument since it reduces the value of the call feature built into a convertible instrument and, thus, causes the security to be priced closer to that of a similar security that does not have the convertibility feature. For example, if a ten-year convertible debenture is callable by the issuer after three years, investors are forced to evaluate the security as if it includes a call right on the underlying security for only three years as opposed to ten years (because investors assume that if the market price of the underlying common stock is above the effective call price at the initial call date, the issuer will call the security and the investor will be forced to convert.)

6. Put Features

Put features are less common than call features and give investors the right to require the issuer to redeem or repurchase the convertible instrument on a specified date prior to maturity at a specified price. Ordinarily an issuer will be required to redeem the shares for cash but sometimes it will have the option of redeeming with shares. A put option will increase the investment value of a convertible because of its shortened maturity (and the shortened period the investor bears the risk of a deterioration in the creditworthiness of the issuer).

7. Delayed Convertibility

Some convertible instruments are issued on a delayed convertibility basis. These securities may either specify the conversion price on initial issuance or may provide that the conversion price will be set at some time prior to the time the security becomes convertible (but limiting the future conversion price to a specified range to protect both the issuer and the investor from dramatic swings in the market price of the underlying security). One benefit of deferring the convertibility of an exchangeable instrument applies where an issuer is subject to resale restrictions with respect to the underlying security under Rule 144 or Rule 145 under the Securities Act of 1933. If the exchangeable security does not become exchangeable for at least one year following the issuance of the security, then the issuer will not be deemed to have offered or sold the underlying security under the Securities Act at the time of initial issuance (or until the instrument becomes exchangeable). This additional period may be necessary to the extent that the issuer of the underlying security is not willing or able to register the offering of the underlying securities in connection with the offering of the convertible instrument (and the issuer expects to be free to sell the underlying securities within one or two years following initial issuance.) This possibility will not apply where the issuer is an “affiliate” of the issuer of the underlying equity securities (and a registration of the sale of the underlying securities will be required).

8. Merger and other Adjustment Provisions

The governing instruments will generally provide that in the event of a merger, recapitalization or other transaction or event effecting the underlying securities, the convertible instrument will thereafter become convertible into the type and amount of securities, cash or property receivable by holders of common stock as a result of the applicable transaction or event. Where the transaction or event results in the underlying security being replaced by cash or property other than exchange-traded equity securities, the operation of these adjustment mechanisms may become quite complex and, particularly in the case of mandatorily convertible instruments, may result in a partial or total acceleration of the maturity of the convertible instrument.

E. Regulatory Framework for Issuance of Convertibles

The SEC has jurisdiction over options directly on securities. In addition each stock exchange has specific standards that must be met as a condition to listing and registration. These include minimum size and distribution requirements as well as minimum financial standards for the issuer. The purpose of these standards is to ensure that issuers can meet their financial obligations to investors and that there will be sufficient public distribution for the securities.

A public offering of convertible securities requires registration of the underlying common stock if the securities are immediately convertible, because the issuer is deemed to be making a concurrent offering of the underlying common stock. Common stock issued upon conversion of a convertible instrument is exempt from registration because it is considered a security exchange by the issuer with its existing security holders. A registration statement covering convertible securities will not be able to specify the number of shares being offered

since this is a function of the conversion price which may not be fixed until the securities are ready to be sold. A footnote providing for the registration of "such currently indeterminate number of shares of common stock as may be required for issuance upon conversion of the [debentures] [preferred stock] being registered hereunder" will be sufficient to register the required number of shares of common stock. The actual number of shares into which the offering is ultimately convertible will not affect the registration fee.

IV. Case Studies in the Use of Convertibles

The following is a discussion of a series of exchangeable and convertible instruments issued by a variety of issuers relating to the PCS Common Stock of Sprint Corporation, three of which were issued by substantial third party holders of the Sprint PCS stock and one of which was utilized by Sprint Corporation directly as means of completing a financing in a very unfavorable equity and debt financing market.

A. Cox Communications Offering of Subordinated Discount Debentures Exchangeable for Shares of Sprint PCS Stock or Cash with an Equal Value.

In April, 2000, Cox Communications completed an offering of debentures with an issue price of \$425.89 and an original principal amount at maturity in 2020 of \$1,000 (representing an annualized yield to maturity of 5%). Under the terms of this offering, Cox agreed to make cash interest payments twice each year at the rate of 1% of the issue price. At any time over the term of the debenture its principal amount is its issue price plus accrued and unpaid original issue discount, subject to decrease by the amount of certain special cash payments. The holder is entitled on the maturity date to receive payment of the adjusted principal amount of the debenture. During the term of the debenture the holder may exchange it for cash equal to 7.5908 shares of Sprint PCS stock attributable to the debenture (the value of such shares on the date the debentures were issued represents a 4.5% discount from the purchase price), cash equal to the value of such shares or a combination of both. Upon the holder's exercise of its exchange right, it relinquishes its right to coupon payments.

At the time this offering was made, Cox had large holdings of Sprint PCS common stock that had appreciated significantly. Cox chose to make its offering to lock in its gains on the Sprint shares without disposing of them outright and incurring substantial taxable gain on sale of the underlying PCS common stock. In issuing the debentures, Cox did run the risk that the PCS common stock would continue to appreciate such that the 7.5908 shares exchangeable for each debenture would be worth significantly more than the accrued value of the debenture. This risk was mitigated by a term of the issuance that enabled Cox, five years from the date of issuance, to redeem the debenture for cash equal to each debenture's adjusted principal amount plus unpaid cash interest. Presumably, the effective interest rate payable by Cox on the debentures was substantially less than the interest rate that it would have been required to pay on any placement of straight debt with similar terms (other than interest rate and exchangeability). Cox's built-in redemption right also gave it the flexibility to "refinance" the terms of its offering in the event of changes in the debt markets that made such a refinancing more favorable than the 5% premium it was paying on the debentures.

B. Liberty Media Offering of Debentures Exchangeable for Sprint Corporation PCS Common Stock or Cash with an Equal Value

In November 1999, Liberty Media issued 4% senior exchangeable debentures with an original principal amount of \$1,000. Interest payments are made on the debentures twice a year. Liberty also agrees to make an additional distribution of cash or securities that corresponds to any dividends, distributions or other payments made in respect of shares underlying the exchangeable debentures. For each such distribution a corresponding reduction will be made on subsequent interest payment dates so that the annualized yield does not exceed 4% per annum. The debentures mature in 2029, 30 years after their original issue date. Holders have the option to exchange each debenture for the exchange market value of reference shares attributable to the debenture. At the time of issuance, the securities underlying the debentures were shares of Sprint PCS stock, but Liberty retained the option to change the identity of the underlying instrument to shares of another company. For the first two years after issuance, the debentures are exchangeable for cash only, thereafter they may be exchanged for cash, shares or a combination of the two. Liberty has the option to redeem the debentures in whole or in part, at any time after November 15, 2003.

30 days prior to the maturity date for the debentures, Liberty has the right to announce that shares will be delivered to holders of the debenture upon their maturity, or that their exchange right has been terminated as of such date. If the exchange right has been terminated, upon the maturity date the holders will receive the greater of the adjusted principal amount of the debenture and the current market value of the shares (based on the average closing price over the previous 20 days) plus any accrued but unpaid interest on the debenture up to the stated maturity date plus any final distribution owed at the time. If the exchange right has not been terminated, on the maturity date the holders receive an amount equal to the adjusted principal amount of the debenture plus accrued interest on the debenture plus any final distributions owed on the debenture.

As with Cox's debentures, Liberty's offering provided the opportunity to lock in gains on underlying Sprint shares by enabling the issuer to earn a return on an exchange of the shares without making an outright disposition of them. Liberty incurs less risk than Cox because the reference shares exchangeable always have the value of the adjusted principal amount of the debentures. Since Cox's debentures are exchangeable for a fixed number of shares, it could stand to lose significantly if the share price of reference shares went up. The option of changing the reference shares to shares of another company gives Liberty additional flexibility should it prove more beneficial (either due to dips in Sprint's share price or due to increased holdings of some other company's shares that have increased significantly in value) to do so. As in the case with Cox, the instrument provides an opportunity to receive the functional equivalent of a 30 year loan at an interest rate much lower than it would receive on the debt market. In addition, the obligation is viewed by rating agencies as less onerous than straight debt.

C. Comcast Corporation Offering of Debentures Exchangeable for Cash Based on Value of Sprint Corporation PCS Stock

In November, 1999, Comcast issued subordinated debentures exchangeable for cash based on the value of Sprint Corporation PCS Stock. Comcast makes quarterly interest

payments at a rate of 2% per year on the original principal amount of the debentures plus any cash dividend or other distribution paid on the reference Sprint PCS shares. The aggregate payment over the life of the bond will be limited to 2%, with adjustments to the amount of any subsequent interest payments for any distribution made on the reference shares. Comcast reserves the right to defer its interest payments for up to 20 consecutive quarters. The initial principal amount of each of the debentures is \$81.6325. Upon maturity of the debentures in 2029, the holder is entitled to receive the higher of the initial principal amount or the sum of the market value of any deferred interest payments plus, in either case, the final period distribution. Prior to maturity the debentures are exchangeable for cash equal to 95% of the value of the reference Sprint PCS stock, or 100% of such value if the exchange occurs during a period of deferred interest payments by the issuer. Comcast has the right to redeem all of the debentures for the sum of the higher of the initial principal amount or the sum of the current market value of the reference shares plus any deferred interest payments, plus a set distribution plus an additional amount that decreases depending upon the length of time that has passed since the original issue date.

As in the cases of Cox and Liberty Media, Comcast sought through the terms of its debentures, to lock in gains on its significant holdings of Sprint PCS stock by crafting an exchange of such shares that would not be deemed a disposition. If the reference shares depreciate significantly, Comcast is out the 2% premium paid on the instruments, a figure significantly lower than Comcast would have had to pay if it had sought such financing in the debt markets.

D. Sprint Corporation Offering of Mandatorily Convertible Equity Units

In August, 2001, Sprint Corporation completed an offering of equity units, each of which is comprised of: (i) a purchase contract obligating the holder to purchase \$25 of Sprint PCS common stock in three years at a settlement rate determined by the stock's market value at the time of settlement and (ii) a 5 year, \$25 principal amount, senior note issued by Sprint Capital, Sprint's wholly-owned finance subsidiary, and guaranteed by Sprint. The holder pledges the Sprint Capital notes to secure its obligations under the purchase contract. Prior to the settlement date, the Sprint Capital notes will be remarketed, with the stated interest rate on the notes being reset to ensure that the remarketing proceeds are sufficient to allow the holders to meet their obligations under the purchase contracts. In addition, at any time, holders can substitute Treasuries as collateral for their purchase contract obligations and release their Sprint Capital notes from the pledges.

Holders of the units will receive total cash distributions at a rate of 7.125% of the stated amount for each corporate unit (\$25) per year (i.e. 6.00% of the stated amount per year payable by Sprint Capital on the notes and contract adjustment payments payable by Sprint Corporation at the rate of 1.125% of the stated amount per year). Sprint Capital may not defer payments of interest on the notes, but Sprint retains the right to defer the payment of contract adjustment payments until the purchase contract settlement date.

With this offering, Sprint was able to obligate holders of the units to purchase Sprint PCS common stock in the future at what it hopes will be a higher price than current market prices would otherwise permit. The offering also offers strategic advantages with respect

to Sprint's credit rating, since rating agencies give significant equity credit for the units while the notes are treated as debt for tax purposes and the interest is tax deductible so long as the notes are outstanding.

V. Practical Concerns for Issuing Equity Derivatives

A. Investor Communication and Understanding

At all phases in development of an offering, an issuer will need to remain apprised of investor demand by fielding questions from potential brokers and investors regarding matters like proposed pricing, background research, and tax issues. Such interaction will help the issuer tailor its offering most effectively to the target market while providing insights into the most effective marketing strategies to be used in connection with the offering. Access to distribution channels is crucial to the economic success of a public deal.

B. Research

Thorough research is critical and should evaluate market conditions like expected changes in interest rates and performance projections for the issuer's stock. Solid research will enable the issuer to evaluate the soundness of its offering in light of its overall financing objectives while also shedding insight on marketing strategies for the securities by identifying potential investors.

VI. Use of Equity Derivative Securities as an Investment Tool

From an investor's standpoint, equity derivative securities offer the opportunity for a holder of appreciated portfolio securities to mitigate its risks associated with economic and investment cycles, tax liabilities and other extraordinary events, when its investment portfolio is comprised of concentrated equity positions.

A. Put Options

By purchasing a put option, an investor is protected, until the option matures, against downward stock price movements below the put strike price while the investor continues to participate in any stock price appreciation. Use of a put is particularly valuable to the holder of stock with low cost basis or resale limitations like holding period requirements or volume restrictions. A cash settlement feature of the put option may allow the investor to defer the taxable event that would occur upon the sale of the underlying stock. A put also enables its holder to retain rights of stock ownership, including voting rights and dividends. Among the considerations an investor will want to make before investing in a put are of course, the out-of-pocket expense to pay for the put option. In addition, for federal income tax purposes, the transaction may be subject to the straddle rules, which can apply to defer the recognition of losses, to suspend the taxpayer's holding period, and to require capitalization (rather than a current deduction) of certain associated interest and carrying charges.

B. Equity Collars

An investor can create a minimum and maximum value around its equity position by establishing a collar. This is a two-step transaction, involving the purchase of a put option with a strike price at or below the current stock price, and the sale of a call option with a strike price above the current stock price. The put provides the buyer with the right to sell stock at a specific price on or before a specific date. The call option provides the buyer with the right to buy stock at a specific price on or before a specific date. While the investor can offset the purchase price of the put through the sale of the call, the investor may completely finance the purchase of the put in this manner, resulting in a "zero cost collar". A cash settlement feature may allow the investor to defer the taxable event that would occur upon the sale of the underlying stock. As with a straight put, use of an equity collar enables the investor to retain rights of ownership, including voting rights and dividends. Among the issues an investor will want to consider before using an equity collar are the lost opportunity to participate in any upside stock appreciation above the call strike price and the amount of downside protection that the investor desires to purchase relative to the current market price of the subject security. Equity collars may also be subject to the straddle rules. Equity collars were not included in the "constructive sale" provisions of Section 1259 of the Internal Revenue Code, but the Treasury Department has been authorized to adopt regulations, which could be retroactive in some cases, to treat some kinds of equity collar transactions as constructive sales of the underlying securities.