SEC Reporting & FASB Forum: Complex Financings

September 17, 2014
Agenda

- Warrants
- Convertible debt
- Combining convertible debt offering with an anti-dilutive transaction
Warrants
Warrants

• In private financings for smaller and mid-sized public companies (PIPE transactions) and in public follow-on offerings for these companies, the issuers may be required to issue and sell common stock and warrants or units composed of a share of common stock and a warrant

• For various purposes, the securities exchange rules for listed companies create incentives for transactions that include warrants
Warrants (cont’d)

Basic terms:

- **Level of warrant coverage**: in a common stock and warrant transaction, investors will negotiate the extent of warrant coverage (a percentage of the number of shares of commons stock sold)
- **Transferability**: will warrants be “detachable”?
- **Exercise price**: at market or above current market price
- **Settlement mechanism**: do warrants provide for cash only or cashless (net) exercise?
- **Customary antidilution features**: warrants usually will provide for antidilution adjustments in the case of organic changes, such as stock splits, adjustments, dividends
Warrants (cont’d)

Basic terms: (cont’d)

• “Down round” (or full ratchet) adjustments: compensates an investor to the extent that the issuer sells stock or equivalent instrument at a lower price
  • Would this cause the warrant to be classified as a liability?

• Registration rights: the holder may negotiate to receive the right to have the issuer register the resale of the shares underlying the warrant and may impose penalty payments in connection with the issuer’s failure to meet its obligations
  • This may cause the issuer to have to estimate the associated penalty fees, which may be a contingent liability
Warrants (cont’d)

- Fundamental change provisions: these are intended to provide the holder with some liquidity and preserve value for the instrument if the issuer completed a fundamental transaction
  - Absolute obligation of the issuer to repurchase the security in connection with any fundamental transaction, or
  - May require a cash purchase to the extent common stockholders receive cash compensation in connection with the fundamental change transaction
Convertible Debt
Basic Terms & Conditions

• Coupon rate
  • The annual cash interest payment made by the company to holders of the security, typically paid semi-annually
  • Privately negotiated securities can be structured with a PIK option
  • PIK rate higher than cash rate

• Maturity
  • Typically 5 to 7 years – Can be as long as 20 or 30 years and structured with short dated call options and/or investor put options

• Conversion premium
  • The percentage premium over the stock price at issuance at which investors may opt to convert the convertible security into common stock

• Call protection
  • Period during which the company does not have the right to call securities from investors
  • Typically non-investment grade securities are non-call for life
  • Early call features require attractive coupon and premium terms for investors
  • Provisional call terms depend on stock price performance
Basic Terms & Conditions (cont’d)

• Investor put option
  • Investor’s right to require the company to repurchase bonds

• Takeover protection
  • Fundamental change (cash takeover) triggers investor put option
  • Make-whole payments made to investors upon a cash take-over based on pre-defined prices
  • Cash takeover define as 90% of consideration paid in cash

• Dividend protection
  • Protects the investor from increases in the common stock dividend yield
  • Conversion ratio is adjusted by an amount equal to the value of the common stock dividends paid per bond

• Rank
  • Position in the company’s capital structure
  • Typically unsecured obligations
  • Senior or subordinate
  • Typically structurally subordinated to subsidiary debt, including trade creditors
Debt Covenants

• Convertible debt securities typically do not contain financial covenants, i.e., minimum net worth, maximum leverage, fixed coverage, working capital covenants

• Events that could trigger default include:
  • Payment of securities
    • failure to make principal and interest payments
    • failure to honor conversion obligation
    • failure to honor repurchase notice or repurchase triggered by a fundamental change
    • failure to cure any defaults within a certain period
  • SEC reports
  • Compliance certificates
  • Further instruments and acts
  • Maintenance of corporate existence
  • Rule 144A information requirement
  • Payment of additional interest
Convertible Debt – Benefits & Considerations

• Benefits
  • Tax-deductible interest expense decreases after-tax cost of capital
  • Ability to issue common stock at a premium to current market (conversion settled in stock)
  • Option to minimize share dilution via net share settlement feature (cash or stock settlement)
  • Flexible call structures can reflect the issuer’s view on its stock
  • No financial covenants
  • Appeals to broad investor base

• Considerations
  • Treated as debt on the balance sheet
  • Periodic cash coupon payments (conversion settlement in stock only)
  • Periodic non-cash interest expense (conversion settlement in cash or stock)
  • No equity credit given by rating agencies
  • Share dilution, if converted (FAS-128) or treasury stock method (with cash settled instruments)
  • Obligation to repay principal, if not converted
  • No increase in the public share float prior to conversion (“plain vanilla”)
Settlement Considerations for Convertible Debt

- Convertible bonds can be settled in a number of different ways:
  - “Physical settlement”: Issuer delivers shares upon conversion
  - “Net Share Settlement”: Issuer pays par in cash and delivers shares for the in-the-money amount of the conversion option
  - “Cash or stock in any combination”: Issuer pays cash or delivers stock in any combination at its discretion
  - “Cash settlement”: Issuer pays cash equal to conversion value in all scenarios
  - Settlement method does not impact convertible pricing

Current US GAAP Accounting Treatment Impact

<table>
<thead>
<tr>
<th>Settlement Method</th>
<th>Balance Sheet</th>
<th>Interest Expense</th>
<th>EPS Dilution</th>
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</thead>
<tbody>
<tr>
<td>Physical (Stock) Settlement</td>
<td>Debt</td>
<td>Convertible Coupon</td>
<td>If-Converted Method</td>
</tr>
<tr>
<td>Net Share Settlement</td>
<td>Debt Plus Option</td>
<td>Straight Debt Cost</td>
<td>Treasury Stock Method</td>
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<tr>
<td>Cash or Stock in Any Combination</td>
<td>Debt Plus Option</td>
<td>Straight Debt Cost</td>
<td>If-Converted Method</td>
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<tr>
<td>Cash Settlement (1)</td>
<td>Debt Plus Option</td>
<td>Straight Debt Cost MTM of Option Value (1)</td>
<td>None from Convertible Treasury Stock Method from Warrant Strike (1)</td>
</tr>
</tbody>
</table>

Note
1. Typically combined with cash settled bond hedge to offset MTM impact and separately sold net share settled high strike warrant
## Conversion Settlement Impact: Full Share (Plain Vanilla) vs Net Share

<table>
<thead>
<tr>
<th></th>
<th>Full Share</th>
<th>Net Share</th>
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</thead>
<tbody>
<tr>
<td><strong>Conversion</strong></td>
<td>Settled in common stock</td>
<td>Lesser of conversion value or principle amount settled in cash. Premium over par paid in common stock</td>
</tr>
<tr>
<td><strong>Balance Sheet</strong></td>
<td>LTD decreases</td>
<td>LTD decreases</td>
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<tr>
<td></td>
<td></td>
<td>Cash decreases</td>
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<tr>
<td><strong>Stockholder’s Equity</strong></td>
<td>Increases by total shares underlying convertible</td>
<td>Could increase</td>
</tr>
<tr>
<td><strong>Public Float</strong></td>
<td>Increases by total shares underlying convertible</td>
<td>Could increase</td>
</tr>
<tr>
<td><strong>Diluted EPS</strong></td>
<td>“If Converted” method used in diluted EPS calculation [FAS-128]</td>
<td>“Treasury Stock” method used in diluted EPS calculation</td>
</tr>
</tbody>
</table>
Convertible Debt Issuance with a Repurchase
Repurchase Alternatives

• Open market – flexible, low cost, limited by daily volume, no guarantee on execution
• Accelerated Share Repurchase – optional upfront share count redaction; sends positive signal
• Call spread or capped call – structured approach requires initial cash outlay
• Tender offer
## Settlement Considerations for Convertible Debt

<table>
<thead>
<tr>
<th></th>
<th>Evolutionary</th>
<th>Transformational</th>
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<tbody>
<tr>
<td></td>
<td>Low Execution Risk</td>
<td>High Execution Risk</td>
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<tr>
<td><strong>Advantages</strong></td>
<td></td>
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<tr>
<td>Open Market</td>
<td>• Continued stock support</td>
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<td></td>
<td>• “At-market” repurchase</td>
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<tr>
<td></td>
<td>• Maximum flexibility</td>
<td></td>
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<td></td>
<td>• Lowest cost</td>
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<td></td>
<td>• Can be executed in a 10b5-1 program or opportunistically</td>
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<tr>
<td>Prepaid/Accelerated Share Repurchase</td>
<td>• Optional upfront share count reduction</td>
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<tr>
<td></td>
<td>• “At-market” repurchase</td>
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<tr>
<td></td>
<td>• Potential tax efficiencies</td>
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<td></td>
<td>• Strong signal</td>
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<td></td>
<td>• Economic protection/discount available</td>
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<tr>
<td>Tender Offer</td>
<td>• Speed of repurchase completion near current valuation</td>
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<tr>
<td></td>
<td>• Strongest signal</td>
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<tr>
<td></td>
<td>• Liquidity event for investors</td>
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<tr>
<td></td>
<td>• Rapid share count reduction</td>
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<tr>
<td><strong>Disadvantages</strong></td>
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<td></td>
</tr>
<tr>
<td>Open Market</td>
<td>• Limited by daily volume</td>
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<tr>
<td></td>
<td>• Exposed to market price over time</td>
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<tr>
<td></td>
<td>• Share count reduction over time</td>
<td></td>
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<tr>
<td></td>
<td>• Weaker signal</td>
<td></td>
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<tr>
<td></td>
<td>• No guarantee of completion</td>
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<tr>
<td>Prepaid/Accelerated Share Repurchase</td>
<td>• Exposed to market price over time</td>
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<tr>
<td></td>
<td>• Fully funded upfront</td>
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<td></td>
<td>• Commits Issuer to complete repurchases</td>
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<tr>
<td>Tender Offer</td>
<td>• Requires premium to current price</td>
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<tr>
<td></td>
<td>• Investors determine success of tender</td>
<td></td>
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<tr>
<td></td>
<td>• Higher transaction costs</td>
<td></td>
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<td></td>
<td>• No ongoing stock support</td>
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<tr>
<td><strong>Mechanics</strong></td>
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<tr>
<td>Open Market</td>
<td>• Issuer purchases shares in the open market over time</td>
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<tr>
<td></td>
<td>• Can buy back stock during blackout period via 10b5-1</td>
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<tr>
<td>Prepaid/Accelerated Share Repurchase</td>
<td>• Bank sells the block to Issuer upfront</td>
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<tr>
<td></td>
<td>• Bank repurchases stock in the open market over time</td>
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<td></td>
<td>• True up payment and/or additional shares delivered at completion of cover period</td>
<td></td>
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<tr>
<td>Tender Offer</td>
<td>• Issuer specifies a number of shares to be repurchased within a defined price range or at specific fixed price</td>
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<tr>
<td></td>
<td>• Shareholders decide whether they would like to participate in the offer</td>
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<tr>
<td></td>
<td>• Tender offer open for a minimum of 20 days</td>
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<tr>
<td><strong>Documentation</strong></td>
<td></td>
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</tr>
<tr>
<td>Open Market</td>
<td>• Short form appointment letter</td>
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<tr>
<td></td>
<td>• No public documentation</td>
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<tr>
<td>Prepaid/Accelerated Share Repurchase</td>
<td>• Master confirmation</td>
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<tr>
<td></td>
<td>• No public documentation</td>
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<tr>
<td>Tender Offer</td>
<td>• Schedule tender offer filed with SEC</td>
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<tr>
<td><strong>Applications</strong></td>
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<tr>
<td>Open Market</td>
<td>• Desire to maintain flexibility including ability to stop</td>
<td></td>
</tr>
<tr>
<td>Prepaid/Accelerated Share Repurchase</td>
<td>• Minimum value of shares Issuer desires to purchase</td>
<td></td>
</tr>
<tr>
<td>Tender Offer</td>
<td>• Repurchase large block of stock in a short period of time</td>
<td></td>
</tr>
</tbody>
</table>
Issuer is an Exchange Act filer.

* Convert sold in a private placement. Convert has at least a 10% premium (to qualify as a “different security”).

QIBs sell issuer stock to Dealer because QIBs are selling short to hedge the embedded call option that QIBs have purchased indirectly by purchasing the 144A convert.
Happy Meal – with a Forward

QIBs sell Issuer stock to Dealer because QIBs are selling short to hedge the embedded call option that QIBs have purchased indirectly by purchasing the 144A convert.

Dealer holds stock in a separate account to settle forward.

* Convert sold to Dealer in a private placement. Convert has at least a 10% premium (to qualify as a “different security”).

** Issuer enters into a forward contract w/ Dealer to purchase from Dealer shares of its common stock in the future.
QIBs sell Issuer stock to Dealer because QIBs are selling short to hedge the embedded call option that QIBs have purchased indirectly by purchasing the 144A convert.

Dealer holds stock in a separate account to settle forward.

* Convert sold to Dealer in a private placement. Convert has at least a 10% premium (to qualify as a “different security”).
Happy Meal – with a Collar

Cash/Physical Settlement:
Physical Settlement Would Result In Shares Back To Issuer.

QIBs sell issuer stock to Dealer because QIBs are selling short to hedge the embedded call option that QIBs have purchased indirectly by purchasing the 144A convert.

Dealer holds stock to settle Collar. However, Dealer may increase or decrease the number of shares it holds as it dynamically hedges the Collar.

* Convert sold to Dealer in a private placement. Convert has a 10% premium (to qualify as a “different security”).
Happy Meal – with a Call Spread

Cash/Physical Settlement: Physical Settlement would result in shares back to Issuer.

QIBs sell issuer stock to Dealer because QIBs sell short to hedge the embedded call option that they’ve purchased indirectly by purchasing 144A.

Dealer holds stock in a separate account to settle call spread. However, Dealer may increase or decrease the number of shares it holds as it dynamically hedges the call spread.

* Convert is sold to Dealer in a private placement. Convert has at least a 10% premium (to qualify as a “different security”).
Convertible Note Hedge plus Warrant (Call Spread) Overview

- **What is it?**
  - A distinct transaction that serves to increase the conversion premium synthetically on a convertible transaction

- **How does it work?**
  - A call spread is the purchase of a call option struck at the conversion price of the convertible security (lower strike price) and the simultaneous sale of a warrant (call option) struck at a higher exercise price (upper strike price)
  - The number of shares underlying both options is the same amount of shares that underlay the convertible security
  - This transaction enables the company to eliminate EPS dilution economically resulting from the conversion of the convertible up to the upper strike price

- **What is the economic cost?**
  - The Company pays for the call options and receives payment from the sale of the warrants
    - The difference between the purchase of the calls and the sale of the warrants is the net cost of the call spread to the company
Convertible Note Hedge plus Warrant (Call Spread) Overview (cont’d)

• This net cost is treated as a reduction to shareholder equity
• However, the issuer is generally able to deduct the full amount of the purchase price of the call option for tax purposes
• The call spread is worth zero at maturity if the common stock does not trade above the conversion price of the bond

• GAAP diluted share count
  • For GAAP purposes, the diluted share count is determined without consideration to the derivative transaction
Convertible Note Hedge plus Warrant (Call Spread) Example

• Company Issues $125 million of Convertible Notes
  • Stock Price at Issue: $8.25
  • Conversion Premium: 25%
  • Conversion Price: $10.31
  • Shares Underlying Convertible: 12.12 million shares

• Company Purchases Calls
  • Company buys call options covering 12.12 million shares of common stock struck at $10.31 – the conversion price of the convertible notes – from Counterparty
  • Company uses portion of proceeds from bond offering to fund purchase of call options

• Company Sells Warrants
  • Company sells warrants covering 12.12 million shares of common stock struck at $13.20 – a 60% premium to the stock price at issue
  • Company receives proceeds from sale of warrants to Counterparty

• Outcome
  • Company hedges the shares created from conversion of the notes (economically, not for GAAP purposes) up to $13.20 exercise price of the warrants, minimizing share dilution and cost of capital)
Convertible Note Hedge plus Warrant (Call Spread) Example (cont’d)

<table>
<thead>
<tr>
<th>Economic Share Dilution: Convertible Note Hedge Plus Call Spread</th>
</tr>
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<tbody>
<tr>
<td>Share Price</td>
</tr>
<tr>
<td>-------------</td>
</tr>
<tr>
<td>$8.00</td>
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</tbody>
</table>

**Convertible Terms**

- **Issue Amount**: $125,000,000
- **Stock Price at Issue**: $8.25
- **Conversion Premium**: 25%
- **Conversion Price**: $10.31
- **Conversion Settlement**: Cash or Common Shares

**Warrant Terms**

- **Warrant Strike**: 60%
- **Warrant Exercise Price**: $13.20
- **Warrant Settlement**: Cash or Common Shares
ASR – During Trade (cont’d)

• Over life of trade dealer covers short by purchasing shares of the issuer in the open market
• Purchase period will have a fixed starting and ending point, though dealer will have right, upon notice to issuer, to cut short the purchase period
• An average price (A) will be determined for the purchase period
  • Typically will be based on 10b-18 VWAP for every trading day during the purchase period, minus an agreed discount or price adjustment
ASR-At Maturity (cont’d)

• If average price (A) is below the initial price (B), then the dealer will owe the final settlement to the issuer:
  • In general, ASRs will provide that the dealer will make physical settlement by delivering extra shares to the issuer:
  • The number of extra shares will equal:
    • The amount the issuer paid at trade inception divided by A minus the number of shares the dealer sold to the issuer at trade inception

• If the average price (A) is above the initial price (B), issuer will owe the final settlement to the dealer
  • The issuer will have the election to make settlement either in cash or by delivery of additional shares
  • However, when settlement is due from the issuer, more complex settlement mechanisms are triggered to address various securities law issues raised by the prospect of an issuer issuing shares
Collared ASR

In many respects similar to basic ASR:

- Issuer executes an accelerated share repurchase program to repurchase shares at a discount to the average 10b-18 VWAP over the term
- Issuer spends a fixed dollar amount to repurchase stock
  - total number of shares repurchased equals:
    - upfront payment divided by [Average Daily 10b-18 VWAP-discount], subject to a minimum and maximum number of shares
    - total repurchase cost fixed upfront
    - shares repurchased at a discount to average daily 10b-18 VWAP

However, collar protects issuer if stock price appreciates and allows issuer to participate in price depreciation up to the minimum repurchase price
Collared Forward Share Repurchase

• Issuer pays a fixed aggregate purchase price
• Dealer delivers a variable number of shares determined on a per-share purchase price equal to the average price which is subject to a collar
  • Cap on average price equals strike price of a call option purchased by the issuer on its own stock
  • Floor on average price represents strike price of a put option purchased by the dealer on the stock
• Permits issuer to retire the minimum number of shares at inception of trade (boosts EPS)
• Lets issuer repurchase shares at average price over term minimizing volatility
Collared Forward – At Inception

Issuer → Dealer

Aggregate purchase price

Issuer → Market

Minimum number of shares

Dealer → Lender

cash

Dealer → Market

Initial hedge

Dealer → $
Collared Forward Share Repurchase

• Parties agree aggregate price, floor on per-share price and cap on per-share price
• Issuer pays aggregate price
• Dealer establishes initial hedge for collar by buying shares over a period of days
• After initial hedge period, dealer delivers minimum number of shares (divide cap price per share into aggregate purchase price)
• At maturity, total number of shares to be purchased is determined by dividing average price over term of trade into aggregate price
• If total number of shares is greater than the minimum number delivered initially, dealer delivers additional shares (but never more than the maximum)
Section 5

• Dealer’s initial sale of shares to the issuer not subject to registration and dealer’s delivery of stock in stock settlement not subject to registration

• If ASR allows issuer to deliver shares at maturity to dealer – the shares will be “restricted securities” in the dealer’s hands
  • Need resale provisions

• Attribution issues:
  • Can dealer’s market purchases be attributed back to the issuer and require that the dealer’s short covering be subject to Section 5 registration requirements?
  • Can dealer’s hedging be attributed to the issuer?
  • Addressed by de-linking transactions so that the issuer doesn’t share in dealer’s losses or benefit from dealer’s gains from hedging
Section 9 and Section 10 of the Exchange Act

• Section 9(a)(2) – cannot effect any transaction or series of transactions in any security that creates actual or apparent active trading in that security, or raises or depresses its price, for the purpose of inducing the purchase or sale of the security

• Section 10(b) – cannot employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security

• Rule 10b-5 – cannot employ any device, scheme or artifice to defraud, make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, or engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security
10b-18 Safe Harbor

• 10b-18 provides a non-exclusive safe harbor from liability under Section 9(a)(2) and 10(b) and Rule 10b-5
• Though 10b-18 does not directly apply to derivatives transaction, most market participants nonetheless rely on 10b-18 by analogy
• SEC Division of Market Regulation: Answers to Frequently Asked Questions Concerning Rule 10b-18 (as modified, November 17, 2004)
  • Question 13: is the Rule 10b-18 safe harbor available for an issuer and the broker-dealer who engage in an accelerated share repurchase plan or use a forward contract to repurchase the issuer’s stock?
10b-18 Safe Harbor (cont’d)

• Answer: Accelerated share repurchase plans and forward contracts are private (off-market) transactions. Therefore, they are not eligible for the Rule 10b-18 safe harbor, which applies only to open market purchases. Moreover, the Rule 10b-18 safe harbor also is not available for the broker’s covering transactions, as these transactions are not agency or riskless principal trades effected on behalf of the issuer.

• The conditions of 10b-18 include:
  • A single broker or dealer making purchases/sales on a single day
  • Trading window
  • Price restrictions
  • Volume thresholds
Rule 10b5-1

- 10b5-1 establishes an affirmative defense to claims that a person has made a purchase or sale on the basis of material nonpublic information
- An issuer also may rely on 10b5-1 for itself
  - Issuer should represent that it is not in possession of material nonpublic information when entering into the ASR/CASR
  - ASR/CASR will not permit the issuer to influence the bank’s purchases or to share material nonpublic information with the dealer
  - Issuer will not be able to change terms, except when it can represent that it is not in possession of MNPI
  - Program may establish black-outs (most arrangements then extend the term of the ASR/CASR for each black-out day)
- If a transaction gives an issuer any option (such as whether to make cash or physical settlement), the issuer may be required to repeat its representation that it does not possess MNPI if it makes such election