“INTELLIGENT DESIGN”

EVOLUTIONARY CHANGES IN EQUITY DERIVATIVES

LEADING PROPONENTS of “intelligent design” tell us that you cannot have it both ways. It’s either intelligent design or spontaneous evolution. They may know their theology, but they don’t know much about equity derivatives. In equity derivatives, intelligent design and structuring are the keys to the evolutionary process that fuels the growth of this market. The equity derivatives market continues to see product innovation and extension. In collaboration with our investment bank clients, we address a variety of legal and documentation issues presented by this continuing development.

In the case of equity derivatives designed for issuer counterparties, we have worked with our clients to implement and refine innovations for structures that have become core product offerings. For example, the now well-honed accelerated share repurchase transaction responded to counterparty demand with more extensive offerings of capped and collared structures. Adding capped calls and collars to the basic accelerated repurchase trade has involved careful recalibration of the securities law analysis underlying these transactions. The strength of the convert market also has led to a significant volume of bond hedge/warrant and capped call deals, which typically are executed on short time frames and with underlying documentation often in a state of flux until pricing. While most of these deals relate to Rule 144A convert offerings, several have been completed in connection with registered convert offerings, which has required reassessment of the securities law issues arising in connection with dealer hedging activities. The prevalence of convert issuances by REITs made the contribution of our tax colleagues particularly critical for capped calls executed in those instances. A noteworthy trend in this area is the growing sophistication of issuer counterparties as evidenced by some of the additional terms they seek to negotiate for these transactions, as well as their tendency to insist that transactions be bid out among a group of competing dealers (some of which, in the case of convert deals, did not participate in the placement or underwriting of the convertible bonds). This trend only intensified the need for prompt analysis and document turnaround, thereby permitting our clients to remain competitive without sacrificing their risk analysis and compliance standards.

Our work in the balance of the equity derivatives arena reflects the increasing variety of reference asset structures. We address bilateral trades, as well as structured notes, in which multiple stock indices, often tested over multiple periods, are inputs to settlement computations. Volatility and variance based trades also are more evident, in part due to the substantial industry effort to develop accepted documentation formats for the interdealer trading community. In our structured notes and bilateral trades work, we are encountering heightened use of foreign equities, sometimes, but not always, through referencing ADRs or ADSs.

In sum, we have decided to leave the great theological questions of the day to others. As for our perspective concerning equity derivatives, we believe intelligent design and evolution have no choice but to live happily ever after.