



The SEC Issues Interpretative Letter on Certain Hedging Transactions in Respect of Restricted or Control Securities

December 7, 2011

The staff of the Division of Corporation Finance of the Securities and Exchange Commission (the “Staff”) issued an interpretive letter on December 1, 2011 to Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Inc. (the “BAML Hedging Letter”)¹ which has significant implications for both holders of restricted securities and affiliates holding securities of an affiliated issuer (“control securities”) who wish to hedge their economic exposure to such holdings through the use of equity forwards and options without involving any registered offer and sale of these securities.

The BAML Hedging Letter harmonizes the interpretive guidance given by the Staff in two earlier letters—one letter (the “1999 Private Hedging Letter”)² with respect to certain prepaid share forward transactions hedged initially on an unregistered basis in accordance with the requirements of Rule 144 under the Securities Act (which we refer to later as a “Rule 144-compliant initial hedge”) and another letter (the “2003 Registered Hedging Letter”)³ with respect to forward and option-based transactions hedged initially on a registered basis .

The BAML Hedging Letter both (1) expands the scope of the 1999 Private Hedging Letter to cover all forward and option-based contracts covered by the 2003 Registered Hedging Letter and (2) clarifies the Staff’s view on ongoing hedging adjustment purchases and sales of the dealer (commonly known as “dynamic hedging activities”) in connection with forward and option-based transactions with Rule 144-compliant initial hedges. In doing so, the BAML Hedging Letter provides clarification and confirmation of the Staff’s view that (1) holders of restricted or control securities may hedge their holdings on an unregistered basis using forward contracts and option-based contracts with Rule 144-compliance initial hedges and that (2) in connection with such contracts, dealers may, subject to certain conditions, offer and sell securities as part of their dynamic hedging activities on an unregistered basis.

¹ Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter, available at <http://sec.gov/divisions/corpfin/cf-noaction/2011/boaml120111-5.htm>.

² See Goldman, Sachs & Co., SEC No-Action Letter (avail. Dec. 20, 1999).

³ See Goldman, Sachs & Co., SEC No-Action Letter (avail. Oct. 9, 2003).

A. EXPANSION OF DERIVATIVE PRODUCTS COVERED BY THE 1999 PRIVATE HEDGING LETTER

The 1999 Private Hedging Letter relates to prepaid variable share forward contracts between Goldman, Sachs & Co. (“Goldman”) and holders of restricted securities or control securities providing for the sale of these securities. The securities subject to the forward contract would be pledged to Goldman to secure the delivery obligations of the shareholder under the forward contract. The BAML Hedging Letter expands the applicability of the 1999 Private Hedging Letter to other forward and option-based transactions (*i.e.* transactions involving one or more options, such as call options, put options, collars, call spreads, put spreads and other combinations of puts and calls) covered by the 2003 Registered Hedging Letter.

Specifically, the BAML Hedging Letter, together with the 1999 Private Hedging Letter, provide that, upon the satisfaction of the requirements listed below, the restricted or control securities pledged to the dealer in connection with any share forward or option-based transaction may be treated as securities that are neither restricted securities nor control securities when used by the dealer in transactions for its own account. Moreover, any securities returned to the shareholder counterparty on settlement of the forward or option-based transaction will no longer be restricted securities under Rule 144(a)(3).⁴ The relevant requirements set forth in the two letters include:

- at the time the parties enter into the forward or option contract, the shareholder counterparty must be able to sell outright in reliance on Rule 144 the maximum amount of the securities deliverable upon settlement;
- when the parties enter into the contract, notice on Form 144 must be filed; and
- promptly after entering into the contract, the dealer must introduce into the public market a quantity of securities of the same class equal to the maximum number of shares deliverable under the contract in a manner compliant with the requirements of Rule 144.

B. CLARIFICATION OF THE STAFF’S VIEW ON DYNAMIC HEDGING

The BAML Hedging Letter also harmonizes the guidance on dynamic hedging activities of the dealer in connection with forward or option-based transactions with Rule 144-compliant initial hedges with the guidance given by the Staff in the 2003 Registered Hedging Letter. The BAML Hedging Letter provides that the existence of a forward or option-based contract will not affect any exemption from registration otherwise available to the dealer’s dynamic hedging sales in connection with such contract if (1) the initial sale of the maximum number of shares subject to such forward or option-based contract is accomplished in compliance with Rule 144, and (2) the dynamic hedging sales are made in a manner entirely consistent with the provisions of the 2003

⁴ If the counterparty is an affiliate of the issuer, the restrictions that result from the relationship of control continue to apply.

Registered Hedging Letter, which sets forth requirements such as (x) the dealer's dynamic hedging activities are conducted in the dealer's sole discretion, (y) the hedging counterparty does not have any economic interest in these activities and (z) the dealer's dynamic hedging activities do not affect the terms of the forward or option-based contract.

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For more information about any of the foregoing, please contact a member of the Firm's Derivatives Practice Group.

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