

Risk

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ZERO-COST COLLARS

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A GROWING NUMBER of individuals in the US are holding stock that has ballooned in value during the current stock market expansion. Their "problem" now is how to preserve their wealth in the event of a severe stock market correction. Many are nervous about holding an inordinate portion of their net worth in a single stock that may be restricted (such as stock received from an employer that is subject to holding or trading limitations) or was acquired at a low cost. The traditional method of reducing risk is to sell your holdings – but profits are then subject to US capital gains tax.

While there used to be various ways to reduce or avoid this tax, most of these seem now to be ruled out by the US Taxpayer Relief Act of 1997. Provisions in the new tax laws treat the following as "constructive sales", otherwise known as "taxable events":

- shorting against the box (selling borrowed stock at the current market price in order to lock in a profit);
- exchange funds that use shorting against the box (depositing stock in a trust in return for units in a diversified portfolio);
- equity swaps (the exchange of periodic cash payments with a counterparty in order to lock in a specific stock price); and
- forward stock sales.

It seems the only game left in town is one of the oldest. "Zero-cost collars", which have been used since the US Put and Call Dealers Association was formed in the 1950s, are now attracting intense interest. These allow investors temporarily to sidestep capital gains tax legally – while locking in stock profits within a pre-determined range and drawing money out of the market for other uses, such as reinvestment.

To qualify for a zero-cost collar transaction, an investor usually needs at least \$2 million of stock in a company that is publicly traded in the US. At least, this is the usual economic threshold required by the financial firms that structure the products. The share price should be \$10 or more, the aggregate market capitalisation of the company should be at least \$250 million, and the stock should have good average daily trading volume. If the stock holdings don't meet these criteria, the position may be combined with others', provided it is the same stock. Incidentally, in establishing a zero-cost collar around restricted stock

or stock acquired at a low price, an investor suffers no out-of-pocket expense, hence the name "zero-cost". The stock is not sold and voting and dividend rights are retained.

Here is how collars work. The ownership of common stock includes the ownership of a certain payout curve, such as stock price increases and decreases. The components of a stock's payout curve have value. They can be stripped away and bought and sold using derivative instruments, including custom-made, over-the-counter put and call option investment contracts.

Zero-cost collars allow an investor to retain a certain specified portion of the future price appreciation of a stock, say 25% (more or less), and sell off the rest of the upside in the form of an out-of-the-money call option. The longer the term of the option (usually one to five years), the greater the upside percentage the investor can keep in the stock (10%, 20%, 30%, 40%, 50% or more).

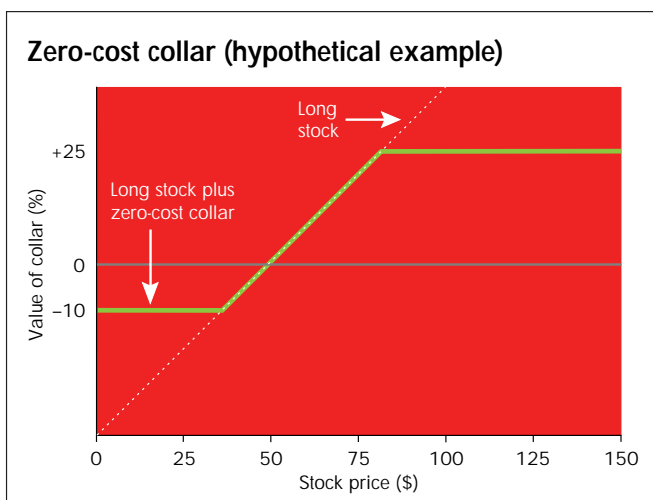
The value a call option commands in the institutional derivatives markets can be used, dollar for dollar, to pay for downside price protection in the form of an out-of-the-money put. Let's say a put is set at 10% below the current market price of the stock. The call price is set so that it equals the value of the put. "Parity" is then said to be achieved. The value of the put and call are about equal and now form a "collar" around the stock. Since the put provides protection to the investor only when the stock price falls by more than 10%, the investor is deemed to be at risk. This risk usually means the transaction is not characterised as "a constructive sale" by the US Internal Revenue Service, and so is not subject to capital gains tax.

Alternatively, the starting price of the call option in this example could be set at 25% (more or less) above the current stock price. Therefore, the investor retains 25% of the future appreciation potential of the stock. The portion above 25% is sold, typically to an international financial firm. The stock is now said to be "hedged", not perfectly, since some downside risk remains, but adequately for structuring the collar.

The financial engineers who structure zero-cost collars compensate themselves by adjusting the put and call prices enough to garner a profit or "spread" out of the option positions. Once the stock is "collared", it can be "monetised" using low-interest bank financing. Subject to certain restrictions, the loan proceeds can be used for reinvestment in the stock and bond market or for other purposes.

The counterparty to a zero-cost monetising collar transaction is usually an international investment-grade financial institution that buys the call from – and simultaneously sells the put to – the investor. It then lends the investor 70–85% of the market price of the stock. Incidentally, the value of this loan in a collar transaction is not subject to margin calls (requests from broker-dealers for more loan collateral from their clients when a stock price falls). This is because a collar (specifically the put option in a collar) protects the stock and transforms it into good collateral for a loan. With a collar in place, the only thing the investor has to worry about is the stock price falling by 10% to the starting level of the put option – below that, they are protected.

A put provides the investor with "insurance" on the stock price, a floor price below which they receive a cash payment from the counterparty. If, on the expiry of the collar, the stock price is down by more than 10%, the investor collects a payment equal to the difference between the starting price of the put and the price of the stock on expiry. The investor can use any cash proceeds from exercising the put to help repay the loan when the collar expires. If, on expiry of the col-





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lar, the stock price is between the put and call prices, both options expire worthless and the investor just pays the loan back.

The loan in a collar transaction is usually provided at a relatively low rate of interest (eg, three-month floating rate Libor plus about 100 basis points, currently about 6.75%) compared with traditional broker-dealer margin loans. The interest may be payable upfront, annually, semi-annually or quarterly and is usually tax-deductible in the US against other investment income, such as dividends. The entire loan proceeds can be used for almost anything, including reinvestment in a diversified stock and bond portfolio, real estate investments, a new business, or even a yacht! If additional securities investments are made, US Treasury rules may limit common stock and corporate bonds purchases to approximately two-thirds of the loan proceeds. The remainder may be invested in virtually anything else, including US Treasury and agency securities.

A collar position can usually be "unwound", or reversed out of, at any time. The investor, using the services of a financial engineer, merely buys in the call and sells back the put, often to the same counterparty with whom the initial transaction was entered into. A collar that expires may also be re-established around the then current market price of the stock. A new loan can usually be secured and the old loan repaid simultaneously.

Although collars do not give rise to capital gains tax liabilities, there are reporting requirements associated with them. Chief executive officers or other corporate staff are usually required to file Form 4 and, in some cases, Form 13-D information statements with the Securities & Exchange Commission shortly after establishing collar positions. CEOs may consider finessing perceived public relations problems that may arise from collaring their stock by explaining to analysts, shareholders and board members that:

- the stock used in a zero-cost collar transaction has not been sold;
- the upside appreciation potential and downside price risk have been retained; and
- voting and dividend rights are maintained.

As the collar position is a financial management strategy used for personal portfolio protection, these reasons are generally appreciated by all interested parties. CEOs and other corporate staff should also be aware that they may be subject to SEC short-swing profit rules that require that any trading profits they personally realise from transactions in their company's stock during the six months prior to establishing a collar have to be returned to the company.

The paperwork involved with establishing a monetising collar transaction is about as voluminous as the documents used in obtaining real-estate mortgage financing. Collars can be set up in about 10 days to two weeks, or longer.

With zero-cost and monetising collars, investors can hedge their exposure to stock market price risk, pull money out of their stock position(s) using a low-interest loan and reinvest the proceeds without paying the capital gains tax until some future date, when and if the stock is actually sold. But investors thinking of entering into such deals are strongly urged to consult their financial and tax advisers first. ■