



MOORS & CABOT
INVESTMENTS

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FREQUENTLY ASKED QUESTIONS

What are zero-premium collars and pre-paid variable forward sales?

Moors & Cabot's Single Stock Risk Management Group specializes in negotiating and structuring transactions which can reduce and manage equity risk, may provide tax-deferred liquidity, and allow retention of ownership and upside in equity positions. This process utilizes derivative options, which are private contractual agreements between the investor and an institutional counterparty. The options used in these strategies are privately negotiated and are not publicly traded options or futures.

Many high-net-worth investors who hold large, concentrated stock positions have enjoyed the long-running bull market, but - in recent times - have seen the value of their portfolios fluctuate with movement of the price of one stock. Ironically, these clients are now most fearful of what made them wealthy in the first place - having much of their portfolio tied to the performance of a single stock - and now they want to protect their good fortune, so to speak. Clients who hold restricted or unregistered shares may also be precluded from selling stock due to legal or regulatory restrictions. Investors who hold these "frozen" stock positions often find hedging strategies attractive because they overcome many of the roadblocks that may exist with an outright sale of stock.

Two strategies in particular address many of the investment needs and objectives of these high-net-worth investors: a "zero-premium collar" and a "pre-paid variable forward sale." Each strategy will reduce downside price risk and allow continued participation in stock gains to a particular level, and both strategies can be structured so that the client will not incur any out-of-pocket cost.

A zero-premium collar can be utilized for clients who are interested in reducing the downside price risk in their concentrated equity position. The structure of a collar is as follows: an investor enters into a contract with an institutional counterparty to receive "stock protection" in exchange for limiting his upside in the stock during the term of the contract. The collar allows the client to reduce and manage his price risk, and provides overall stability for his portfolio. Although the client's potential upside in the stock will be limited, many investors agree that a cap on upside potential well above the current price is a reasonable consideration for the security and peace of mind of gaining downside price protection.

A pre-paid variable forward sale can be utilized for clients who are interested in generating tax-deferred liquidity from their hedged stock position. This liquidity may be used to further reduce risk through asset diversification, or used to fund insurance, estate, and financial planning needs. Depending on prevailing market conditions, the client may receive a one time tax-deferred payment of approximately 75% to 90% of the value of his stock position. This up-front payment does not require periodic debt service, and the client will not incur margin call risk or a floating interest rate. Since there has been no sale of stock, the client will retain complete ownership and control of his stock during the term of the transaction.

Options may not be suitable for all investors and there are significant risks inherent in the use of options, even when options are used for hedging purposes. Moors & Cabot, Inc. does not provide legal, tax or accounting advice and the information contained herein should not be construed as such. Investors should be aware of potential risks with their counterparty, including credit risk, possible restrictions on stock transfer and jurisdictional tax requirements. This is not intended to be a complete summary of the transactions discussed above.

At the maturity of the contract clients may simply deliver some or all of the shares hedged (depending on the stock price), or may deliver the cash equivalent value. They may thus defer any capital gains tax while enjoying liquidity derived from the underlying stock. Clients may also choose to maintain their hedged position by restructuring the transaction at maturity. Of course, clients should be sure to consult their personal tax advisor for their interpretation of whether these types of transactions are appropriate.

However, neither strategy is without risk, and both advisors and investors must be aware of these risks prior to entering into the transaction. In the case of “zero-premium collar,” an investor’s risk includes the complete loss of premium paid for the put, the complete forfeiture of any gains above the call strike price, counterparty risk, downside price protection less than 100% of the initial stock price, and the possible requirement to physically deliver the stock. For a “pre-paid variable forward sale,” an investor’s risk includes the complete loss of any costs associated with the structure, the complete forfeiture of any gains above the upper strike price, and the requirement to physically deliver 100% of their shares.

How are covered call options different from transactions such as zero-premium collars and pre-paid variable forward sales?

A recent New York Post article referenced a current arbitration case where many UPS retirees were promised “no downside” risk when entering into covered call writing strategies with their Merrill Lynch advisor. Covered call writing occurs when a short position is taken in a call option against a long position in the underlying stock. While the risks and rewards of covered call writing may be appropriate for some, they are not appropriate for investors looking for considerable downside protection. They are, however, more suitable for those investors who are looking for some level of liquidity and who believe the underlying stock will remain at the current price or decline in value.

Transactions such as zero-premium collars and variable pre-paid forward sales can be attractive alternatives for investors who believe their stock will appreciate to some level, but understand a concentrated stock position makes up a large portion of their net worth and are looking for downside price protection and the ability to monetize their holding and defer taxes.

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These transactions are binding, contractual agreements with a specified maturity. However, in practice, counterparties are typically willing to terminate early or renegotiate the original contract and terms. The counterparty is not *required* to change any terms of the contract; their willingness to do so is determined on a case-by-case basis, and may be subject to additional costs and expenses.

These transactions can generally be settled in cash or stock. Investors should specify in their *original* contract which delivery alternative they prefer. These transactions can be customized for any number of shares and any specific maturity date.

Institutional counterparties generally require investors to have a minimum net worth of \$2-5 million for these transactions.

Options are not suitable for all investors.

Contact Moors & Cabot’s Single Stock Risk Management Group at 999 Vanderbilt Beach Road, Naples, FL 34108 for a current options disclosure document, “Characteristics and Risk of Standardized Options.” This document discusses potential risks with options issued by the Options Clearing Corporation (“OCC”), which are typically listed on an exchange. It may not discuss the additional risks of privately negotiated option contracts, and investors should be aware of potential risks with their counterparty, including credit risk, possible restrictions on stock transfer, and foreign jurisdictional tax requirements.

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Taxes, fees and commissions do have a direct and material impact on the options strategies, may reduce the effectiveness of some strategies and may result in the investor not achieving his or her investment objectives. Please note that additional taxes, fees, and commissions may have a direct and material impact on the *renegotiation* of any options strategy.

The examples presented above do not take into account the tax consequences or the impact on holding period. Investors should always seek professional tax advice before engaging in any of these strategies. Moors & Cabot, Inc. does not provide tax advice.

Clients should understand they may not be entitled to increases in cash dividends on their underlying stock, or to any extraordinary dividends or other payments. They should consult their own legal and tax advisors regarding their responsibility for taxes on such dividends, regardless of whether they are entitled to retain those dividends under their transaction documents. They should also understand their dividends may not constitute qualified dividend income for income tax purposes. Moors & Cabot, Inc. does not provide legal, tax or accounting advice and the information contained herein should not be construed as such.

All information contained herein is qualified in its entirety by the information contained in a final confirmation or other materials to be prepared in connection with any transaction. Additional information is available upon request.

Options are not suitable for all investors and there are significant risks inherent in the use of options, *even* when options are used for hedging purposes. The information contained herein has been prepared from sources believed to be reliable, but is not guaranteed by us and is not a complete summary or statement of all available data.

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