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Continuous Equity Financing with Forwards: A Practical Solution to Strategic Capital Raising

About this White Paper

Continuous Equity Financing with Forwards: A Practical Solution to Strategic Capital Raising was developed by BNY Mellon Capital Markets and Dewey & LeBoeuf to identify the key factors and outline the necessary steps issuers should consider when contemplating a continuous equity financing program. The paper also thoroughly explores the rationale and mechanics of including a "forward component" in a continuous equity financing program.

While this paper was written with the needs of chief financial officers and chief counsels in mind, it also can serve as a valuable resource for anyone involved in managing corporate liquidity. We believe that continuous equity financing programs will continue to be a valuable strategy for qualifying issuers looking for effective tools to help them raise capital.

Introduction

As the financial markets began to emerge from the latest economic crisis, issuers increasingly employed at-the-market continuous equity financing programs to raise capital. Also known as sales agency programs or equity "dribble-outs," as well as by many acronyms (such as "SAFE"[1] programs or "ATM[2] equity"), these financing programs are designed to allow issuers to quickly and opportunistically access equity markets, especially during periods of high volatility when a "traditional" equity issuance may not be economically attractive. Continuous equity financing programs also allow issuers to raise equity capital as the need arises by selling shares of their common stock from time to time through a designated broker-dealer sales agent at current market prices. Issuers often find these programs attractive because they give issuers considerable control over the timing, amount, and price of each issuance and sale of their common stock. Continuous equity financing programs will likely not completely replace the traditional follow-on equity offering, since the capacity of a continuous equity financing program is limited by the issuer's market liquidity (a combination of average daily trading volume and share price). The programs, however, do provide a supplemental means to access equity capital.

While continuous equity financing programs have been around in some form since the 1980s, program structure and documentation became more standardized in the early 2000s as more issuers utilized the at-the-market strategy. With the SEC's adoption of significant securities offering reforms in 2005, which, among other things, eliminated a prior 10% issuance limitation on at-the-market offerings, continuous equity financing programs have become a viable strategy for a growing number of issuers. There has been a remarkable increase in continuous equity financing programs filed in recent years, with over 40 programs filed in the first half of 2010 and 90 programs filed in 2009, compared to approximately 30 programs filed in 2008.[3] Continuous equity financing programs have been used by issuers in a broad range of industries, including by real estate investment trusts, investor-owned utilities, airlines, financial institutions, and technology companies.

1. "SAFE" is an acronym for "Sales Agency Financing for Equity."
2. "ATM" is an acronym for "At-The-Market."
3. Sources: EDGAR filings, BNY Mellon Capital Markets, LLC data.

A new feature has recently been added to these programs that provides continuous equity users with additional flexibility. By coupling these financing programs with forward contracts, issuers can, in effect, access public markets at a time when they consider their stock to be trading at favorable prices and defer settlement to future dates when they are in need of capital. Generally, under these programs, the issuer enters into a privately negotiated[4] forward contract to sell shares at future dates of its choosing based on market prices prevailing at the time the forward contract is entered into. For example, an electric utility expanding its power generation capacity will typically finance the construction with a combination of debt and equity to maintain a debt-to-equity ratio target established by the utility's regulatory body. The issuer can "lock in" current market prices for its shares and coordinate the share settlement to meet anticipated capital requirements when needed Other issuers, such as REITs, that may be potentially seeking acquisitions could enter into forward contracts based on current market prices and then choose to settle once acquisitions are finalized.

Although unique legal[5] and accounting[6] issues will need to be addressed, the addition of a forward component to a continuous equity financing program can arm issuers with a powerful, new tool in their capital-raising arsenal.

The purpose of this paper is to explore the integral steps taken and the factors to be considered in adding a forward component to a continuous equity financing program. As you will read, this option may not be an appropriate strategy for all issuers. Factors such as market liquidity, availability of borrowable shares and program costs may make adding a forward component impractical or unfeasible, and issuers should discuss the merits and costs of a continuous equity financing program with qualified counsel or their investment banker.

4. The Dodd-Frank Wall Street Reform and Consumer Protection Act, or the Reform Act, was enacted on July 21, 2010 and requires certain security-based swaps to be cleared and traded on an exchange or security-based swap execution facility. The SEC will have the authority to determine which security-based swaps (or groups, categories, types, or classes of security-based swaps) will be subject to these clearing and trading requirements. Forward contracts entered into in connection with continuous equity financing programs are not expected to be subject to these clearing and trading requirements. Moreover, even if clearing and trading were required for this type of forward contract, a party to the contract that is not a "financial entity," as defined in the Reform Act, and that is using the contract to hedge or mitigate commercial risk may, subject to certain notice requirements, elect not to have the contract cleared and traded. The Reform Act also requires the SEC to issue rules imposing margin requirements on the uncleared security-based swap positions of security-based swap dealers and major security-based swap participants. It is currently unclear whether these margin requirements will apply to the uncleared security-based swap positions of entities that are not "financial entities."

5. The information contained in this paper should not be construed, or relied upon, as legal advice. Readers should consult their counsel on all legal matters.

6. The authors of this paper are not accountants and are not qualified to render accounting advice. Issuers should consult their accounting personnel and outside auditors to analyze the accounting issues raised by these programs.

The Basic Continuous Equity Financing Program

Setting up a continuous equity financing program is in many respects similar to the process of preparing for a traditional follow-on public equity offering.

Board Authorization of Sales

Corporations setting up a continuous equity financing program should be aware that certain state law requirements (including Delaware's) impose a statutory duty on the issuer's board of directors to determine the price at which its stock can be sold. In certain jurisdictions, this duty may not be discharged by setting a floor price or by delegating this duty to executive officers of the issuer.

This requirement for board approval of all the terms of each sale under a continuous equity financing program potentially poses a logistical impediment, given how frequently and quickly sales can be made under the program. Issuers have addressed this issue in several different ways. Depending on the law of the applicable jurisdiction and the charter documents of the issuer, one potential solution is to have the board appoint a pricing committee for the program, and that committee may consist of only one member, so that the entire board is not unduly burdened by individual sales decisions. Alternatively, other issuers have taken the position that it is proper under the law of the applicable jurisdiction for a board of directors to simply approve "at-the-market" sales under the program because, given the nature of the program, this approval is tantamount to the board authorizing a specific price.

Registration and Prospectus Delivery under the Securities Act

Continuous equity financing programs are registered under the Securities Act of 1933 using a shelf registration statement that complies with Rule 415(a)(4) under the Securities Act, which applies to at-the-market[7] offerings. Most significantly, this requires the issuer to be eligible to register a primary offering on Form S-3 or Form F-3.[8] To be eligible to register a primary offering on those forms, the issuer generally must, among other things:

- have been subject to SEC reporting requirements, and have timely filed its SEC reports,[9] during the period beginning twelve full calendar months before the filing of the registration statement; and
- not, since the end of the last fiscal year for which it has filed audited financial statements with the SEC, have:[10]
  - failed to pay any dividend or sinking fund installment on preferred stock; or
  - defaulted on indebtedness for borrowed money or any long-term leases, which defaults, in the aggregate, are material.

7. An "at-the-market" offering is defined for these purposes as an offering of equity securities into an existing trading market for outstanding shares of the same class, at other than a fixed price.
8. Form F-3 is generally available only to foreign private issuers and certain of their majority-owned subsidiaries. However, foreign private issuers that elect, pursuant to Rule 13a-16(a)(4) under the Securities Exchange Act of 1934, to file reports with the SEC as domestic issuers may also be eligible to use Form S-3. Many unique issues not addressed in this paper arise under the federal securities laws for foreign private issuers, and those issuers should consult their U.S. counsel regarding these issues.
9. There are exceptions to this SEC filing requirement, including for certain current reports on Form 8-K.
10. This requirement also applies to the issuer's consolidated and unconsolidated subsidiaries.

In addition, issuers that have a public float[11] of less than $75 million generally cannot sell more than one-third of their public float in primary offerings of non-investment grade securities for cash using registration statements on Form S-3 or Form F-3 during any twelve-month period. Under Rule 415(a)(5) under the Securities Act, a registration statement for an at-the-market offering can be used for a maximum of three years from the date it initially becomes effective under the Securities Act. However, this three-year limit may be extended in certain cases if the issuer[12] files a new registration statement to roll over shares that remain unsold at the end of three years. Well-known seasoned issuers are eligible to file a registration statement on Form S-3 or Form F-3 that will become effective immediately upon filing.

A preliminary prospectus is not used in continuous equity financing programs, and there is no "road show" where the issuer's management participates in marketing activities for the offering. Generally, a final prospectus supplement will be filed pursuant to Rule 424 under the Securities Act to disclose the terms of the program, including:

- the identity of the broker-dealer acting as sales agent through whom the offering will be made and the agent's commission;[13]
- the maximum number of shares, or the aggregate gross proceeds of the shares, to be offered;
- a plan of distribution that contemplates sales, from time to time, of common stock into the existing market at prevailing market prices; and
- in the case of a continuous equity financing program with a forward component, a description of the related forward contracts and sale of borrowed shares, each of which is described in more detail below.[14]

A final prospectus must be delivered for each sale. However, the sales agent will typically rely on Rule 153 under the Securities Act, which generally deems the final prospectus filed with the SEC to have been constructively delivered in transactions between brokers and dealers that are effected on or through a national securities exchange or certain other trading platforms and that comply with certain other requirements of Rule 153. Rule 153 will not be available for sales that the sales agent makes directly to one of its customers who is not a broker or dealer. For those sales, Rule 172 under the Securities Act may deem the final prospectus to be constructively delivered, but Rule 173 under the Securities Act requires the agent to deliver a notice in lieu of the final prospectus.

Because continuous equity financing programs involve periodic sales over an extended period of time, the issuer must ensure that materially accurate and complete information regarding the issuer and the shares being sold is made available to investors at the time each contract of sale is entered into. Accordingly, the issuer and sales agent will ensure that the prospectus is updated as needed during selling periods. In addition, the sales agency agreement between the issuer and the sales agent will usually allow the issuer to suspend sales under the program for any reason, including to update disclosure in the prospectus.

11. Public float generally means the aggregate market value of the issuer's voting and non-voting common equity held by non-affiliates of the issuer.

12. To be a well-known seasoned issuer, an issuer must, among other things, have a public float of at least $700 million or have issued, in the past three years, at least $1 billion aggregate principal amount of non-convertible securities (other than common equity) in primary offerings for cash registered under the Securities Act. Certain issuers, including blank-check companies, asset-backed issuers, investment companies, certain shell companies, and issuers that have recently been subject to bankruptcy proceedings or been convicted of certain crimes, are precluded from being well-known seasoned issuers.

13. The commission for continuous equity financing programs has historically been between 1% and 3% of the sales price.

14. Issuers generally also include risk factor disclosure relating to the forward contracts. For example, see the prospectus supplement filed with the SEC by Westar Energy, Inc. on April 2, 2010 pursuant to Rule 424(b)(5).

Although often not definitively named as an "underwriter" in the deal documents (the broker-dealer's appointment is as an agent for the issuer), the sales agent ordinarily will be deemed to be an underwriter under the Securities Act. Accordingly, the sales agent will generally be subject to the same liabilities as an underwriter of a traditional firm commitment underwritten offering and will conduct the necessary due diligence as it would with any public offering of securities.

The Sales Agency Agreement

The issuer and the designated broker-dealer sales agent[15] will enter into a sales agency agreement. At its most basic level, the agreement gives the issuer the right to instruct the sales agent to sell shares on its behalf[16] during the term of the program. The sales agent's obligation to sell shares is typically on a "commercially reasonable," rather than a "firm commitment," basis.

Because the sales agent is ordinarily considered an "underwriter" under the Securities Act, the sales agency agreement is very similar to an underwriting agreement for a traditional follow-on public equity offering. Accordingly, the sales agency agreement contains standard representations, warranties, and covenants by the issuer, conditions to the obligations of the sales agent (including the delivery of legal opinions with 10b-5 negative assurances, comfort letters[17] and other closing documents, which we refer to as the "deliverables"), and indemnification provisions.

These deliverables typically must be delivered upon the execution of the sales agency agreement and the filing of the prospectus supplement and sales agency agreement with the SEC. Because sales will be made on a continuous basis, however, the sales agent will want to remain current in its diligence of the issuer throughout the term of the program in order to establish a due diligence defense. As such, throughout the term of the program, the agent will request "bring-down" due diligence sessions with the issuer and updated deliverables, usually on a quarterly basis or upon the occurrence of a material change in the issuer's business or financial condition.

Unlike a standard underwriting agreement for a traditional equity offering, the sales agency agreement does not contain a "lock-up" provision.

Once executed, the sales agency agreement is filed with the SEC as an exhibit to a current report on Form 8-K, which is automatically incorporated by reference into the registration statement.

15. It is becoming more frequent for issuers to include multiple sales agents in the program. Where more than one is used, only one of the agents will be permitted to sell shares on behalf of the issuer on any particular day. The issuer will frequently enter into separate, but identical, sales agency agreements with each sales agent.

16. The designated broker-dealer will typically act as agent, and not as principal, in selling the shares. However, sales agency agreements often include a mechanism under which the broker-dealer may purchase the shares as principal.

17. In offerings that are registered under the Securities Act, auditors generally can deliver comfort letters only to underwriters or to other persons that have a statutory due diligence defense under the Securities Act. Because the sales agent is typically not definitively named in the base prospectus or prospectus supplement as an "underwriter," some accounting firms have insisted, as a condition to delivering a comfort letter, on receiving a legal opinion or a representation letter from the sales agent concluding that the sales agent has a due diligence defense under the Securities Act.

Selling Mechanics

When the issuer desires to access the equity market using a continuous equity financing program, it will deliver a transaction or issuance notice to the sales agent, instructing the sales agent to sell shares. This transaction notice will specify:

- the number, or the gross dollar proceeds, of shares to be sold by the sales agent;
- the sales period during which those sales are to be made (subject to a maximum duration of, for example, 10 business days);[18] and
- the minimum price per share at which the sales agent may sell the shares.[19]

Upon receipt of a transaction notice, the sales agent will commence selling the issuer's shares, often through Electronic Communications Networks (ECNs) or on the stock exchange on which the stock is listed, utilizing the issuer's existing market liquidity. The sales agent will sell shares throughout the trading day, in volumes usually averaging less than 15% of the issuer's average daily trading volume, in order to avoid putting downward pressure on the share price. The sales agent will update the issuer about the day's trading activity and discuss alternative trading strategies with the issuer as market conditions change. The sales are often made in ordinary brokered transactions, with no special selling efforts.[20] Each day's sales of shares into the market during the sales period settle in the ordinary course, typically on a T+3 basis.[21] Except in the case of sales relating to a forward contract, at each settlement, the issuer delivers shares against payment by the sales agent of the purchase price less the sales agent's commission. The sales agent will provide the issuer with a daily trade blotter at the end of each selling day, detailing the number of shares sold and the prices at which they were sold.

Upon settlement, the issuer instructs its transfer agent to credit the sales agent's account at DTC for the number of shares sold, and the sales agent wires the net proceeds to the issuer. If the sales relate to a forward transaction, no shares or sales proceeds will be exchanged between the sales agent and the issuer. Instead, as described in more detail below, the sales agent will sell borrowed shares (as opposed to new shares to be issued by the issuer at settlement), and each sale will be settled between the buyer and the sales agent acting on behalf of the forward purchase counterparty.

As a matter of practice, issuers will not permit sales under the program during "blackout periods" imposed by their insider trading policies, and these periods can vary widely from issuer to issuer. At other times, an issuer may be in possession of material non-public information, which would preclude it from selling its securities. Many issuers will "go dark" immediately following their quarter-end and remain dark until their quarterly report is filed with the SEC. Issuers should consult counsel to determine the appropriate periods in which they should not be in the market.

18. Alternatively, some continuous equity financing programs contemplate that the issuer will instruct the sales agent on a daily basis as to how many, or the dollar gross proceeds of, shares to sell each day.

19. The issuer has the ability, by notice to the sales agent, to change the minimum price during the sales period.

20. These sales are generally executed without any special selling efforts in order to avoid triggering a "distribution" under Regulation M. In SEC Release No. 33-7375 (December 20, 1996), the SEC stated that sales of securities in ordinary trading transactions into an independent market without any special selling efforts will generally not constitute a distribution under Regulation M, provided that the sales agency agreement does not contain unusual transaction-based compensation for sales. If a distribution occurs, Regulation M prohibits the issuer, all distribution participants and certain affiliated persons from directly or indirectly bidding for or purchasing, or attempting to induce any person to bid for or purchase, the issuer's common stock during a specified period before the distribution is complete, subject to exceptions. An issuer in a continuous equity financing program should consult its counsel regarding whether the issuer should, as a matter of caution, restrict its activities during sales periods under the program.

21. In other words, each sale will typically settle on the third business day after the trade date of the sale. This is the default settlement cycle set forth in Rule 15c6-1 under the Securities Exchange Act for securities transactions through a broker-dealer.

Disclosure and Public Communications

The issuer will often issue a press release announcing the establishment of the program. This "launch" press release should comply with Rule 134 under the Securities Act, which provides a safe harbor for certain communications that would otherwise be deemed to be a prospectus. In the absence of a press release, public notice is clearly evident with the filing of the prospectus supplement and the sales agency agreement. The press release provides the issuer with an opportunity to further describe the rationale for its program.

During the course of the program, the issuer will disclose the aggregate sales made under the program periodically in its annual and quarterly reports that it files with the SEC.[22] However, more prompt disclosure on a current report on Form 8-K may be advisable for sales that, individually or in the aggregate, are material to the issuer. Since materiality is not defined for these purposes with bright-line rules, the issuer should consult with counsel for guidance. However, if the sales are made pursuant to a forward transaction, then the resulting forward contract may need to be reported on an Item 3.02 Form 8-K if the number of shares underlying the forward contract is at least 1% (or, in the case of smaller reporting companies, 5%) of the total number of outstanding shares.[23] Upon completion of the program, issuers may also issue a press release announcing the conclusion of the program and the total sales made under it.

Stock Exchange Notices

The rules of the stock exchange on which the issuer's common stock is listed may require a filing to be made with the exchange in connection with entering into a continuous equity financing program. For example, NASDAQ requires 15-day advance notice for certain transactions that may result in the issuance of more than 10% of the outstanding common stock or voting power. The New York Stock Exchange also requires a supplemental listing application to be filed with it for certain transactions that may result in the issuance of common stock. Notice requirements may vary among the different exchanges, especially for transactions involving complex structures. An issuer should contact its stock exchange well in advance of entering into a continuous equity financing program to ensure that it does not inadvertently fail to provide any required notices on time.

Market Impact of Filing

The initial establishment of a continuous equity financing program, and the filing of a prospectus supplement and the sales agency agreement, rarely have a profound adverse effect on the issuer's share price because the market has come to understand that such programs represent an option to issue shares, rather than an obligation to do so. The exact timing of issuances under the program is not disclosed at the time of the program's establishment, and the typical three-year term of the program gives the market little "tradeable" information.

A review of dozens of continuous equity filings since 2008 shows the relative benign impact on share price immediately following the initial public disclosure of a program's establishment. The few instances of negative market reaction to the establishment of a program include filings of programs in excess of 15% of the issuer's market capitalization and filings soon after the closing of a follow-on offering. In most cases where the issuer provided a press release describing the rationale for the program, regardless of relative size, the market impact was generally muted.[24]

22. Some issuers instead periodically file new prospectus supplements reflecting each block of sales, or the aggregate sales during a specified period, under the program.

23. This 1% or 5% threshold applies on a rolling basis. Accordingly, once the number of shares underlying forward contracts entered into since the most recent Item 3.02 Form 8-K or other periodic report reaches this threshold, a new Form 8-K may need to be filed.

24. BNY Mellon Capital Markets, LLC conducted a random survey of over 50 continuous equity financing program EDGAR filings dating back to 2008 and measured relative share price performance and market impact at filing.

As these programs have continued to become more commonplace, and as investors and analysts further comprehend the fundamentals of these programs, the use of continuous equity financing has become a more widely understood issuance strategy.

The Forward Component

As noted above, some recent continuous equity financing programs include a "forward component" that provides the issuer with additional issuance flexibility. In these programs, the sales agent sells borrowed shares into the market on behalf of a forward counterparty, and the issuer and the forward counterparty enter into one or more forward transactions. These forward transactions permit the issuer to issue and sell shares to the forward counterparty from time to time, over a specified period, at a price (called the "forward price") that is based on the actual prices at which the borrowed shares were sold during the applicable selling period. By basing the forward price on the actual prices at which the sales of borrowed shares are effected, the issuer can basically "lock in," subject to certain adjustments discussed below, the price at which it will sell shares to the forward counterparty. Accordingly, if an issuer has no immediate need for capital but believes that its stock price is trading at favorable levels, it may deliver a transaction notice for a forward transaction and settle the resulting forward contract at a later time when it needs capital.

General Mechanics

At the time the program is set up, the issuer enters into a master forward contract with a counterparty that (currently)[25] is typically a banking affiliate of the sales agent. The master forward contract is, in effect, a schedule of terms and conditions that supplements an ISDA master agreement and establishes the basis for issuance and settlement of shares. Each time the issuer delivers a transaction notice for a forward transaction,[26] the issuer and the forward counterparty enter into a corresponding separate forward confirmation setting forth the specific terms of the resulting forward contract. The sales agent is directed by the issuer to sell shares, in an amount specified in the applicable transaction notice, that are borrowed by, or for the account of, the forward counterparty. These sales are marked by the sales agent as short sales[27] under Rule 200 of Regulation SHO. The sales agent then delivers the net proceeds from these sales to the forward counterparty, who often pledges the same to the persons from whom the shares were borrowed. The forward counterparty and share lenders often arrange for some form of "rebate" on any interest that is earned on these proceeds. This rebate is, in certain circumstances, shared between the forward counterparty and the issuer under the forward contract (as discussed below under the caption "Forward Price"). The rebate is not always shared with the issuer, however. For example, in an interest rate environment where the daily U.S. federal funds rate is extremely low (as it is as of the date of this paper, below 1%), the issuer will subsidizes a "rebate" (more accurately, a profit) to the forward counterparty if the agreed-upon spread (see "The Forward Price" below) exceeds the daily U.S. federal funds rate.

Each forward transaction provides for the sale by the issuer to the counterparty of a number of shares of the issuer's common stock equal to the number of shares actually sold short during the related selling period. Accordingly, the forward counterparty will have a short position in the same

25. Under the so-called "push out" provision of the Reform Act, which will become effective no sooner than July 2012, registered security-based swap dealers and major security-based swap participants will be denied certain federal assistance, subject to limited exceptions and grace periods of up to three years. This provision is expected to prompt many insured depository institutions to transfer their derivatives trading activities to an affiliate.

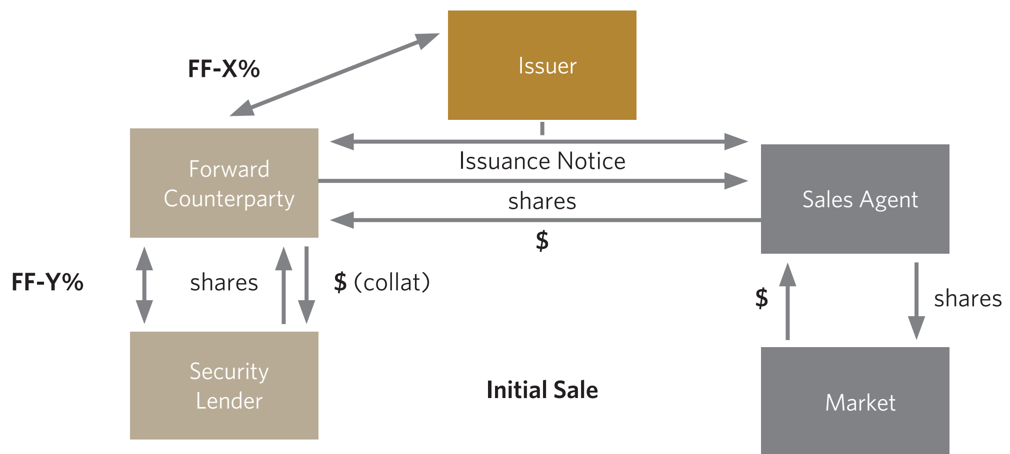
26. While some continuous equity financing programs with a forward component provide only for sales that will be subject to a forward contract, at least one recent program gave the issuer the option to elect whether or not sales pursuant to a particular transaction notice will be subject to a forward contract.

27. A short sale is a sale of a security that the seller does not own or that is settled by delivery of a security that is borrowed by, or on behalf of, the seller.

number of shares which it must receive/purchase upon full physical settlement of the forward transaction. Under each forward transaction, the issuer has the right, exercisable any number of times during a specified period (for example, up to one year), to deliver/sell to the forward counterparty any number of shares, up to the total number of shares underlying the forward transaction.[28] However, by the end of the term of the forward transaction, all shares underlying the forward transaction must be settled.

The following flow chart depicts the equity sale in connection with a forward transaction:

The Forward Price



Source: BNY Mellon Capital Markets, LLC

The forward price is initially set at the volume-weighted average of the prices at which the forward counterparty sold shares short during the related selling period, less a commission. The forward price is then adjusted each day based on a fixed spread below the daily U.S. federal funds rate.[29] For example, if the federal funds rate on a given day is 1.00% per annum and the spread is 90 basis points per annum, then the forward price is adjusted on that day by multiplying the forward price by $\left(1+\frac{0.1\%}{360}\right)$.[30] This adjustment will reduce the forward price if the federal funds rate is less than the spread. This adjustment mechanism reflects, in part, the interest that the forward counterparty expects to earn on the proceeds from the short sales and the stock borrow costs it expects to incur.[31] While the issuer receives no proceeds from the initial (short) sale of shares, it is entitled to a portion of the potential earnings on the proceeds if the federal funds rate exceeds the spread.

The forward counterparty earns a profit based on the difference between the spread and its cost of stock borrow. However, the cost of stock borrow is not fixed, as it reflects the relative supply and

28. Sometimes, however, the forward contract requires each exercise to cover a minimum number of shares or restricts the number of times the issuer can exercise its right to sell shares to the forward counterparty.

29. The federal funds rate is the interest rate at which depository institutions lend balances to each other overnight.

30. The adjustment rate is 1.00% less 90 basis points, which is 10 basis points, or 0.1%, per annum. Dividing by 360 converts this annual rate into a daily rate.

31. If these stock borrow costs increase significantly throughout the term of the program, then the forward counterparty may lose money each day it maintains its short position. However, as described below, if borrow costs exceed pre-agreed limits, then the forward counterparty usually has the right to accelerate settlement of the forward transaction, enabling it to close out its short position and stop incurring those borrow costs.

demand for borrowable shares for a given issuer. Accordingly, it is possible for the cost of stock borrow to rise to the point that it would be impractical for the forward counterparty to continue to maintain its short position.

As described below, the forward price is sometimes reduced to compensate the forward counterparty for dividends the issuer pays on its common stock.

Adjustments to Initial Forward Price to Account for Dividends

During the term of the forward contract, the forward counterparty must pay to share lenders any dividends that are paid on all borrowed shares. These payments to share lenders are sometimes referred to as "manufactured" dividend payments.

As described below, if the issuer does not regularly pay dividends or expect to do so during the term of the program, then the forward contract generally provides that the forward counterparty may force early settlement of the forward contract in full if the issuer declares any dividends on its common stock. This permits the forward counterparty to purchase shares from the issuer and deliver those shares to share lenders before the record date for the dividend, thereby avoiding having to pay a manufactured dividend.

However, if the issuer regularly pays dividends or expects to do so during the term of the program, permitting the forward counterparty to accelerate settlement for regular dividends is impractical. Instead, on each expected ex date[32] for a dividend, the forward price is reduced by the expected dividends per share. Disregarding the time-value of money,[33] this allows the forward counterparty to recoup the manufactured dividends it must pay, by reducing the total price it must pay the issuer when the forward contract is settled. The timing and amount of each reduction to the forward price are agreed in advance, primarily in order to avoid invoking the two-class accounting method for reporting earnings per share.[34] If the issuer declares dividends in excess of these amounts, then the forward counterparty will be entitled to accelerate settlement of the forward contract.

Cash and Net-Share Settlement

The default method of settling the forward contract is physical settlement, where the issuer delivers shares to, and against cash payment from, the forward counterparty. However, the forward contract may allow the issuer (but not the forward counterparty)[35] to elect cash or net-share settlement to apply instead of physical settlement. An issuer may elect to cash or net-share settle if, for example, it determines that it does not want to issue shares or would like to reduce the total number of shares it would otherwise have had to issue upon settlement.[36]

Under physical settlement, the forward counterparty pays the aggregate forward price against delivery of the shares from the issuer. The current market price of the shares has no bearing on

32. The "ex date" of a dividend on shares of common stock is the first date on which the common stock trades, regular way, in the relevant market without the right to receive the dividend. Due to default T+3 settlement, the ex date is, in most cases, the second business day before the relevant record date. A person who executes a trade to purchase shares in an ordinary transaction on or after the ex date of a dividend will not be entitled to receive that dividend.

33. The forward counterparty pays the manufactured dividends on the applicable dividend payment date, while it realizes the reduced forward price only when the forward contract settles.

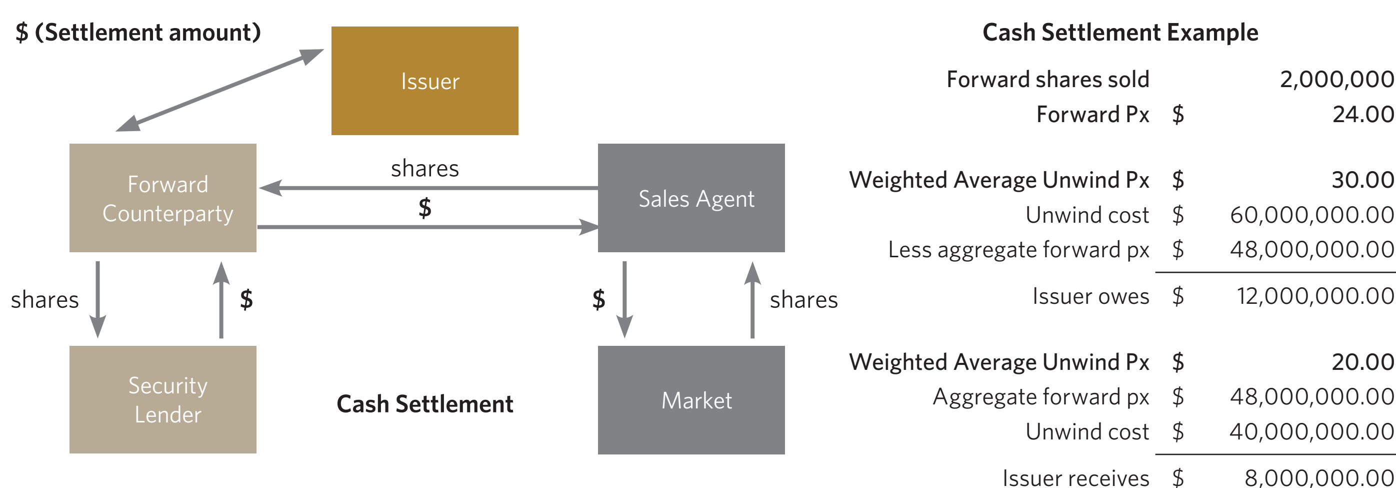
34. Generally, under the two-class method, undistributed earnings are allocated between common stock and all participating securities, which normally results in lower reported earnings per share of common stock. The forward contract is carefully tailored so that it does not constitute a "participating security" for accounting purposes.

35. Allowing the forward counterparty to elect cash settlement generally will cause the forward contract to be subject to mark-to-market accounting, which issuers may view as unfavorable.

36. As described below, cash or net-share settlement may actually result in a cash payment, or the delivery of shares, from the forward counterparty to the issuer.

physical settlement. However, if the issuer opts to cash settle or net-share settle, the market prices of the shares during the period the forward counterparty unwinds its hedge (as described below) affect whether the issuer will receive cash or shares from, or owe cash or shares to, the forward counterparty. For example, if the forward price is higher than weighted average price per share at which the forward counterparty purchases shares to unwind its hedge,[37] then the contract is settled “in the money” for the issuer. On the other hand, the forward contract would be settled “out of the money” for the issuer if the forward price is lower than such weighted average price. If the issuer chooses to cash settle the contract when it is “out of the money” for the issuer, then the issuer must pay cash to the forward counterparty. Conversely, if the issuer chooses to cash settle the contract when it is “in the money” for the issuer, then the issuer will receive cash from the forward counterparty (see examples below).

Net-share settlement is essentially identical to cash settlement, except that instead of one party paying cash, that party delivers a number of shares of the issuer’s common stock that have an equivalent aggregate market value.



Cash Settlement Example

Forward shares sold		2,000,000
Forward Px	$	24.00
Weighted Average Unwind Px	$	30.00
Unwind cost	$	60,000,000.00
Less aggregate forward px	$	48,000,000.00
Issuer owes	$	12,000,000.00
Weighted Average Unwind Px	$	20.00
Aggregate forward px	$	48,000,000.00
Unwind cost	$	40,000,000.00
Issuer receives	$	8,000,000.00

Source: BNY Mellon Capital Markets, LLC

The Forward Counterparty’s Unwind

As described above, the forward counterparty has a physical short position in the same number of shares which it would be required to purchase upon full physical settlement of the forward contract. When the forward contract settles, the forward counterparty delivers the shares, if any, it receives from the issuer to the share lenders. If physical settlement applies, then the number of shares the forward counterparty receives upon settlement is exactly the same as the number of shares it must deliver to share lenders to fully close its short position (*i.e.*, to “unwind” its hedge). This is not the case, however, if cash or net-share settlement applies.

Under cash settlement, the forward counterparty will not receive any shares from the issuer. Under net-share settlement, the forward counterparty will not receive sufficient shares from the issuer to fully close out its short position, and the forward counterparty may in fact have to deliver shares to the issuer. Accordingly, under cash or net-share settlement, the forward counterparty

37. Sometimes, the forward counterparty is compensated for effecting open-market transactions to unwind its hedge by adding a fee, reflecting a sales commission, to this weighted average price.

will have to purchase shares from one or more third parties to settle its short position (and, if the contract is “out of the money” for the forward counterparty and net-share settlement applies, to acquire the shares it must deliver to the issuer upon settlement). The forward counterparty will typically acquire these shares in open market purchases that are designed to comply with the safe harbor provisions of Rules 10b5-1 and 10b-18 under the Securities Exchange Act.

Securities Exchange Act Rule 10b5-1
An election by the issuer to settle in cash or net shares will prompt the forward counterparty to make open market purchases. Because the issuer will settle the forward contract based in part on the prices at which these open market purchases are effected, a regulator or other third party may allege that these open market purchases would violate the anti-fraud provisions of federal securities laws if the issuer made this election while it was in possession of material non-public information. Accordingly, the forward contract typically does not allow the issuer to elect cash or net-share settlement unless the issuer represents to the forward counterparty, at the time of the election, that it is not in possession of material non-public information.

However, the issuer may come into possession of material non-public information after it elects cash or net-share settlement but before the forward counterparty completes its open market purchases. Because of this potential risk, the forward counterparty’s open market purchases are structured to comply with the safe harbor provisions of Rule 10b5-1. These provisions cause purchases or sales of securities to be deemed not to be made on the basis of material non-public information if certain conditions are satisfied. These conditions generally require the following:

- a binding decision to purchase or sell the securities was made, through a contract, instruction, or written plan, before becoming aware of any material non-public information;
- the contract, instruction, or written plan either:
  - contains specific information setting forth the price, amount, and timing of the purchases and sales; or
  - delegates investment decisions to someone who independently makes those decisions without becoming aware of any material non-public information;
- the purchases and sales at question were made pursuant to the contract, instruction, or written plan; and
- the contract, instruction, or written plan was entered into or given in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1.

To satisfy these requirements, the forward contract typically requires the forward counterparty, upon receiving a cash or net-share settlement election notice, to purchase shares at market prices, specifically setting forth the timing and amount[38] of these purchases. The contract often contains provisions expressly prohibiting the issuer from influencing the timing or amount of these purchases or the prices at which they are effected.

38. The number of shares to be purchased during the unwind period typically tracks the volume limitations of Rule 10b-18 described below.

Securities Exchange Act Rule 10b-18

Rule 10b-18 provides a safe harbor to certain anti-manipulation provisions of federal securities laws. Generally, it provides that a purchase of an issuer's common stock by or for the issuer (or certain affiliated persons or persons acting in concert with the issuer) will not violate those anti-manipulation provisions solely by reason of the timing, amount, or price of the purchase, so long as the following conditions, among others, are satisfied:

- the purchase is effected through no more than one broker or dealer on any single day, subject to exceptions;
- the purchase is not the opening purchase reported on the consolidated system and is not effected during the last 30 minutes (or, for securities with an average daily trading volume of at least $1 million issued by companies with a public float of at least $150 million, ten minutes) of the primary trading session;
- certain pricing conditions are satisfied, including a requirement that the purchase price not exceed the highest independent bid or the last independent transaction price; and
- no more than 25% of the average daily trading volume is purchased on any single day, subject to exceptions.

While the forward counterparty's open market purchases to unwind its hedge are arguably for its own account, and not that of the issuer, the purchases are, out of caution, nonetheless designed to comply with Rule 10b-18 as if the purchases were being made by the issuer. Moreover, the SEC has suggested that a person can be deemed to be acting in concert with an issuer in purchasing the issuer's securities even if the purchases are not made for the account of the issuer.[39] The issuer is typically required to covenant that neither it nor any "affiliated purchaser" will take any action that would cause any of the forward counterparty's open market purchases to fail to comply with Rule 10b-18.

The Goldman II No-Action Letter

In October 2003, the SEC issued a letter, often referred to as the Goldman II no-action letter, that set forth a framework under which many investment banks have structured and executed equity-linked derivatives transactions for issuers. In the context of a continuous equity financing program with a forward component, the Goldman II no-action letter allows the forward counterparty to deliver shares it receives from the issuer upon settlement of the forward contract, and shares it acquires in open market transactions in connection with cash or net-share settlement, to close out its short position without any prospectus delivery or registration under the Securities Act.[40] This essentially allows the share lenders to treat the shares they receive from the forward counterparty as non-restricted securities.

39. See SEC Release No. 33-8335 (November 10, 2003).

40. The Goldman II no-action letter in fact enables much more "exotic" types of equity-linked derivatives transactions. While those transactions raise many of the same legal and accounting issues described here, they are beyond the scope of this paper.

Generally, in order for the forward counterparty to rely on the Goldman II no-action letter, the forward counterparty must, among other things, sell, pursuant to the registration statement, the maximum number of shares deliverable by the issuer under forward contract and deliver[41] a current prospectus for those sales. The sales of borrowed shares by the sales agent for the account of the forward counterparty are designed to satisfy the requirements of the Goldman II no-action letter. In addition, the issuer must be eligible to file a registration statement on Form S-3 or Form F-3 for a primary offering and, before entering into the forward contract, must file a registration statement that:

- registers a primary[42] offering of no less than the maximum number of shares deliverable under the forward contract;
- to the extent applicable, includes Rule 415 undertakings and complies with Rule 415(a)(4) relating to at-the-market offerings; and
- contains a plan of distribution that contemplates the forward contract and the related selling activity conducted as part of the forward counterparty's hedging of its exposure under the forward contract.

Acceleration Events

During the term of the forward contract, certain events that were unforeseeable at the time the contract was executed may occur that will make it unduly uneconomical for the forward counterparty to retain its short position. Accordingly, the forward contract will contain provisions permitting the forward counterparty to accelerate settlement (and cause physical settlement to apply) if certain events occur, allowing the forward counterparty to close out its short position. These "acceleration events" may include the following:

- the issuer's payment of extraordinary dividends on its common stock;[43]
- an unexpected increase in the forward counterparty's cost to borrow shares;
- mergers or other extraordinary events involving the issuer; and
- certain changes in law.

Alternatively, some forward contracts may allow the forward counterparty to adjust the terms of the forward contract to reflect the occurrence of these and other types of events. These adjustment provisions raise accounting and other issues that must be carefully circumnavigated.

41. As described above, the parties typically rely on Rule 153 or Rule 172 under the Securities Act, which will deem the final prospectus filed with the SEC to be constructively delivered in certain transactions.

42. The sales of the borrowed shares could be viewed as secondary sales on behalf of the forward counterparty as opposed to the issuer. However, the Goldman II no-action letter requires the registration statement to reflect those sales as a primary offering. Accordingly, the registration statement does not include disclosures under Item 507 of Regulation S-K regarding selling security holders or other related disclosures regarding secondary offerings.

43. As described above, the forward counterparty will have to pay the persons from whom it borrowed shares a payment compensating them for dividends on the borrowed shares.

Certain Accounting Considerations

Forward contracts entered into in connection with continuous equity financing programs potentially raise several accounting issues. These forward contracts often contain many provisions whose primary purpose is to achieve a particular accounting outcome. For these reasons, an issuer contemplating a continuous equity financing program with a forward component should involve its accounting team and outside auditors as early in the process as possible.

Generally, the forward contracts are designed to achieve equity accounting, as opposed to asset/ liability accounting. Under equity accounting, the contract is reflected in stockholders' equity, and subsequent changes in the contract's fair value are not recognized on the issuer's financial statements, so long as the contract continues to qualify for equity accounting.[44] Under asset/ liability accounting, the contract is classified as an asset or liability and marked to market, with changes in fair value being reported in earnings.

After the sales agent has sold borrowed shares pursuant to a transaction notice and a forward contract is entered into, the issuer will typically reflect the shares underlying the forward contract in its diluted earnings per share using the treasury stock method. Under this method, for purposes of calculating diluted earnings per share, the forward contract is assumed to have been physically settled and the issuer is assumed to have used the proceeds receivable from the forward counterparty to repurchase shares.

As discussed above, if the issuer pays regular dividends, the forward price will be adjusted downward to compensate the forward counterparty for manufactured dividends it must pay on borrowed shares. If the contract is not carefully tailored, these adjustments could invoke the two-class accounting method, which could result in lower reported earnings per common share.

The above highlights only some of the relevant potential accounting issues. Issuers should consult their accounting personnel and outside auditors to avoid unexpected accounting results.

44. There are many requirements for equity treatment. For example, the contract cannot force the issuer to settle in cash, and settlement amounts generally cannot be affected by variables that are not inputs to a pricing model for a fixed-for-fixed forward or option on equity securities.

Conclusion

Continuous equity financing programs have become an increasingly important tool in managing corporate liquidity needs and have been adopted by issuers in a broad range of industries, especially over the past two or three years. The attraction of this equity-raising strategy is driven by ease of use, timing flexibility, and generally lower underwriting costs (compared with traditional follow-on offerings). While not a perfect substitute for a large capital raise, at-the-market programs provide a flexible and issuer-friendly means to raise equity over time when, as and if needed. The addition of a forward component option is intended to provide even greater flexibility, allowing an issuer to dollar-cost average the issuance price and target the actual issuance timing to meet the issuer's needs. As mentioned earlier, the forward component may not be practical for every issuer due to factors, such as float, market liquidity, short interest, and investor composition, which may make such an option uneconomical.

Continuous equity financing programs, we believe, will continue to be a valuable strategy that qualifying issuers can add to their capital-raising arsenal. Issuers will be well-served to consider such a program with their counsel and investment bank.

Acknowledgements

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