StockShield

intelligent edge ADVISORS

MAYER • BROWN

Protecting Highly Appreciated Stock Positions

The State of the Art

CFA Society New York Workshop
September 27, 2017

Speakers

- **Tom Boczar, CFA,** is CEO of Intelligent Edge Advisors. Tom is expert in the discipline of single-stock risk management, and has structured and arranged the execution of billions of dollars of single-stock hedging and monetization transactions. Tom is a prolific researcher and has authored over fifty published articles, a number of which have won prestigious awards, on issues related to concentrated wealth and the taxation of financial instruments, products and transactions. Tom holds an LL.M. (Taxation) from NYU School of Law, and a J.D., MBA and Masters in Professional Accounting from the University of Miami. Tom holds an Advanced Professional Certificate in Estate Planning from NYU School of Law, earned IMCA's CPWA designation, and is a CFA charterholder. Tom is admitted to the bar in NY and CT.

- **Mark H Leeds** is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and working with US individuals and family offices. Mark is a frequent writer on tax issues presented by wealth management. Prior to joining Mayer Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice.

- **Brian Yolles** is the founder and CEO of StockShield LLC, and the inventor of the Stock Protection Fund methodology, which has won patent protection and delivered cost-effective results throughout the financial crisis. Brian began his career as an equity research associate at Dowling & Partners Securities LLC, an investment banking and capital markets firm specializing exclusively in the insurance industry, and has over 15 years experience developing new and innovative solutions for managing concentrated stock wealth. Brian is an active member of the Global Association of Risk Professionals (GARP). Brian graduated summa cum laude from Yale University and earned his MBA from the UCLA Anderson School of Management.

- **Elizabeth Ostrander, CFA,** is Managing Director and Head of Business Development at Intelligent Edge Advisors, an investment banking and capital markets firm that works exclusively with financial advisors to plan, structure and execute liquidity events for their clients who have wealth concentrated in privately held businesses, commercial real estate and/or highly appreciated single-stock positions. Elizabeth works with independent broker-dealers, custodians, banks and wealth management firms to make Intelligent Edge's service offering available to financial advisors and their clients. Elizabeth has authored numerous articles on various issues surrounding concentrated wealth, and frequently speaks on the topic. Elizabeth holds a B.A. from Boston College and is a CFA charterholder.

Current State of the Discipline

- **Many investors have accrued significant unrealized gains**
- **Tax expense of outright selling has skyrocketed**
  - Fed cap gains rate increased almost 60% to 23.8%
  - Many states increased their tax rates (average about 6%)
  - Average combined federal and state rate currently about 30%
- **Step-up in tax-cost-basis at death provides opportunity/incentive to *eliminate* the capital gains tax on unrealized gains**
- **Estate tax exemption now about $11 million for married couple**
- **Possibility of tax reform (lower capital gains tax rate?)**
- Sell now and pay a substantial capital gains tax or wait until death and avoid *both* the capital gains and estate tax?

Current State of the Discipline

- **Some investors hesitate to sell their appreciated stock positions for other reasons**
  - Belief stock will further appreciate
  - Dividend yield on stock compares favorably to yields on fixed income securities
  - Strong emotional attachment to stock due to manner shares were acquired
    - Current or past employment with company
    - Sale of family business to public company in exchange for stock
    - Inheritance or gift from a loved one
  - Restrictions compelled by securities laws/regulations or contractual provisions (IPO-lock-up, merger or employment agreement
  - Long-term buy and hold investors

Current State of the Discipline - Defining the Challenge

- **Specific Company Risk**
  - Holding all your eggs in one basket
  - Can be defined and measured in many ways
  - Riskier proposition than most investors believe
    - According to J.P. Morgan: 40% of stocks lost more than 70% of their value between 1980 and 2014.[1]
    - According to Goldman Sachs: Over the past 30 years, more than half of the stocks in the Russell 1000 have underperformed the index itself, while 25% have suffered permanent loss of capital. Permanent loss of capital is "defined as a stock that loses more than 75% of its value and does not recover to 50% of its original value within the last 30 year period as of December 2015."[2]

[1]JPMorgan Chase & Co. *The Agony & The Ecstasy: The Risks and Rewards of a Concentrated Stock Position.* 2014.

[2]Goldman Sachs. *Turning Concentration into Diversification.* 2016.

Complexities And Constraints

- Tax planning – often the driver
- Financial engineering (tool set)
- Margin rules (rules-based v. risk-based)
- Restrictions (regulatory, contractual and corporate)
- Limitations of the capital markets
- Behavioral finance implications
- Risks advisors face if hold out as “expert”

Possible Investor Objectives

- **Preservation of capital (hedging)**
- **Deferral (and possible elimination) of capital gains tax**
- Diversification
- Monetization (generating cash)
- Retain dividends
- Retain upside potential
- Enhance yield
- Wealth transfer
- Charitable planning

Wide Range of Strategies Available to Hedge/Monetize Concentrated Stock Positions

Hold Shares Unhedged	Proxy Hedge	Borrow Against Shares Recourse Debt	Covered Call Writing	Protection Fund	Buy Puts	Cashless Collar	Collar and Loan	Prepaid Variable Forward	Borrow Against Shares Non-recourse Debt	Short Sale or Synthetic Short Sale	Exchange Fund	Tax Managed Index Proxy	Sell Shares Outright/ Gifting

High

Concentration Risk

Low

Key Tax Rules & Concepts Critical to Hedging

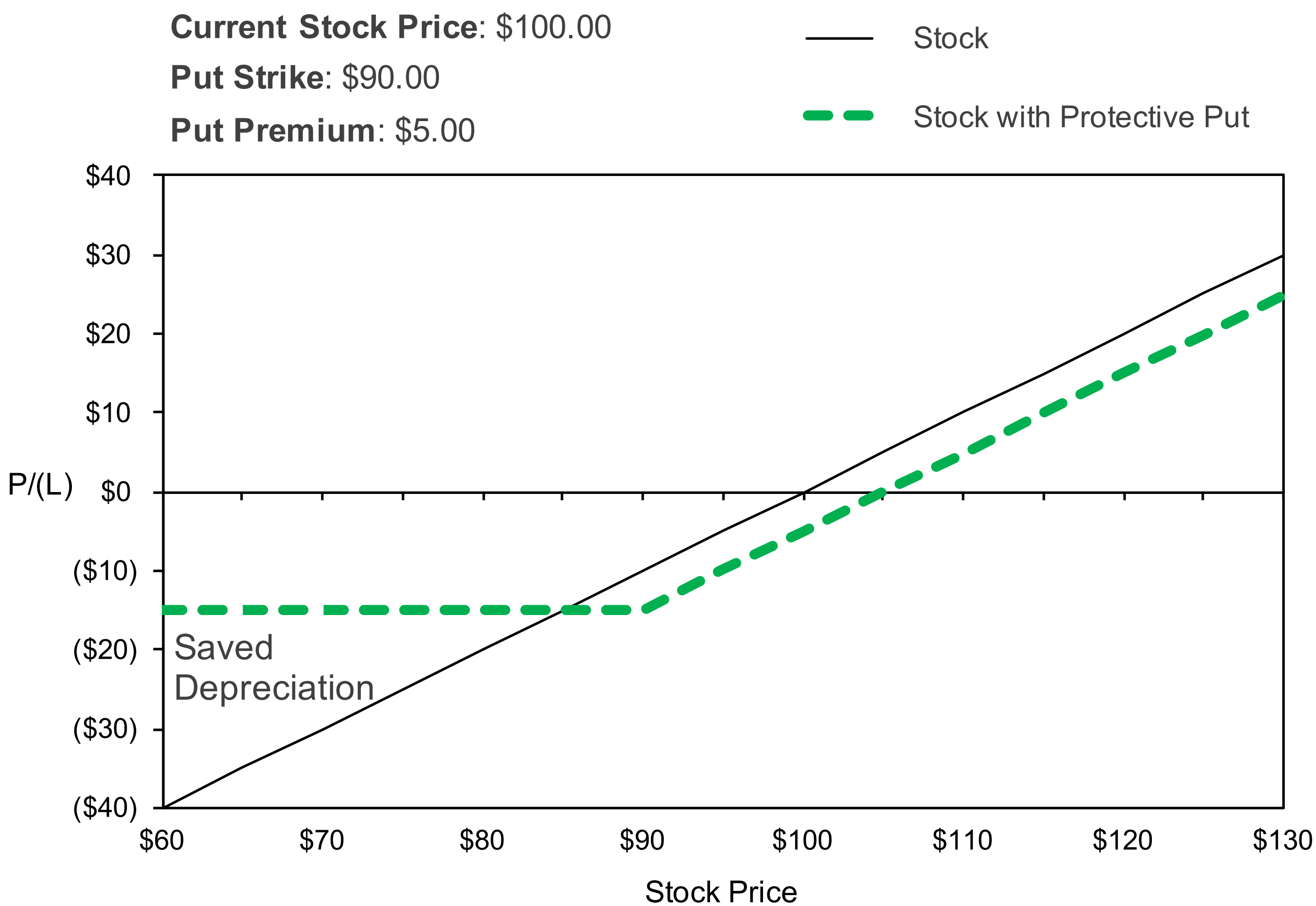
- Common Law Constructive Sale
- Statutory Constructive Sale Rules
- Straddle Rules
- Dividend Holding Period Rules
- Securities Lending Rules
- Step-up in basis at death
- Benefit of tax deferral increases as marginal tax rate increases

Shorter-Term Protection Strategies

- Purchase Puts
- Sell Covered Calls
- Collar the Position
- Short Against the Box

Purchase Put Options

Shareholder pays upfront premium of $5.00 and eliminates downside exposure below $90

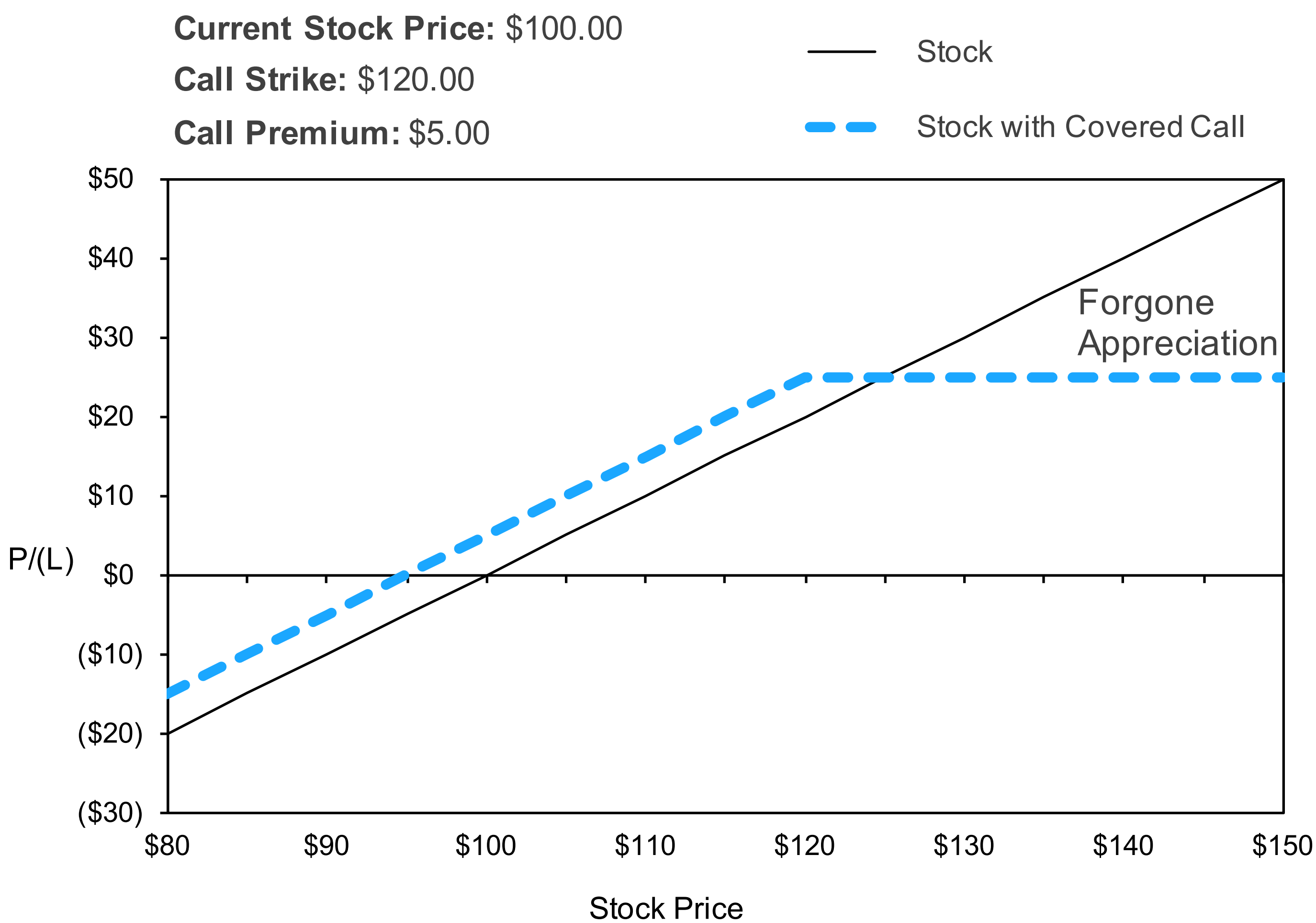


Purchase Put Options

- How to reduce out-of-pocket expenditure?
  - Go shorter-dated
  - Lower the strike price
  - Create a put spread (sell a put with lower strike price than the put purchased)
  - Create a collar (sell off some of the stock's upside to help pay for the put)

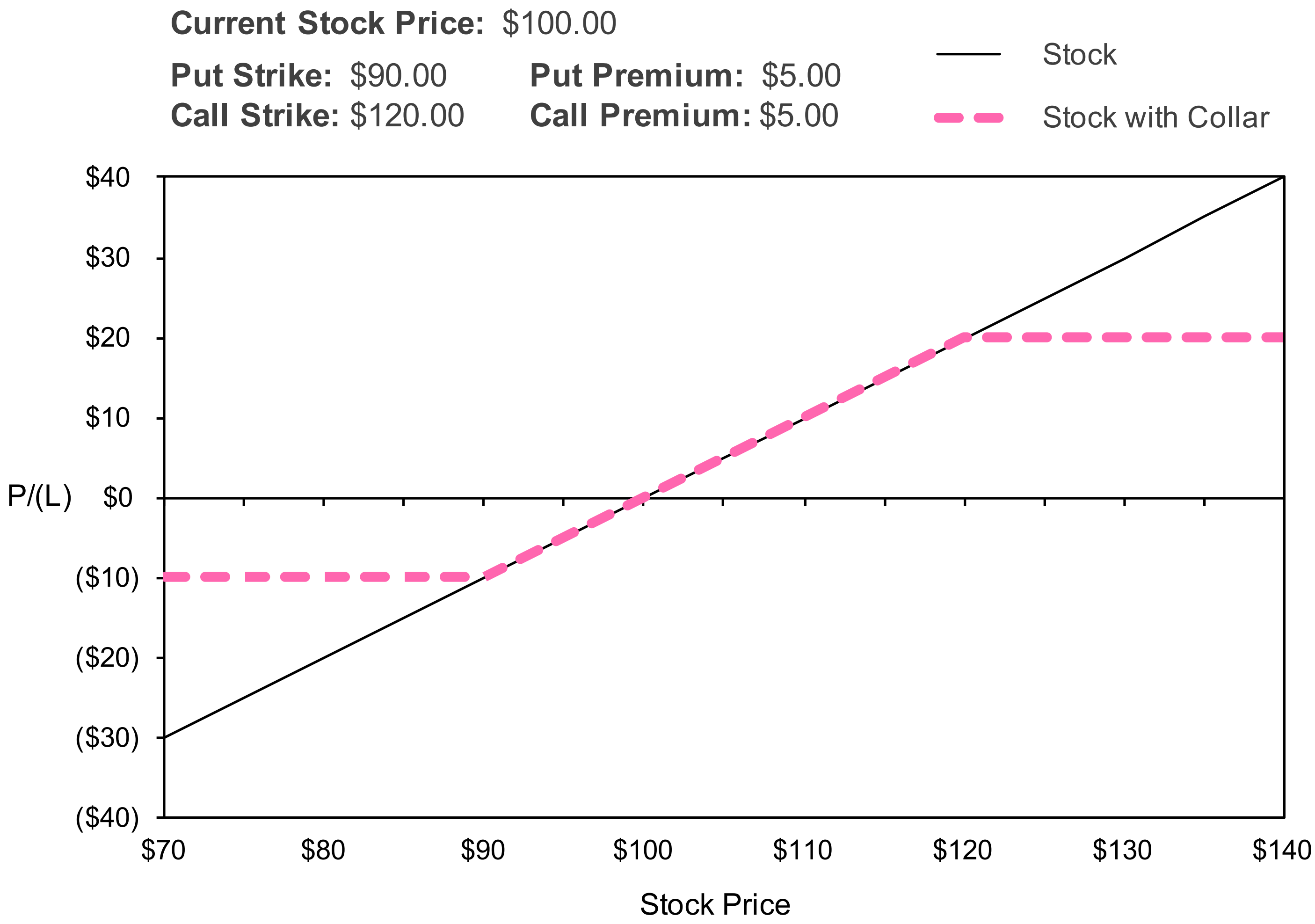
Sell Covered Call Options

Shareholder receives upfront premium of $5.00 and forgoes appreciation above $120



Zero Premium (Cashless) Collar

Shareholder eliminates downside exposure below $90 and foregoes appreciation above $120 with no upfront cash outlay



Zero Premium (Cashless) Collar

- Shareholder eliminates downside exposure below put strike and foregoes appreciation above call strike with no upfront cash outlay

Advantages	Disadvantages
• Lock in gains - Below put strike • Retain limited upside potential - Up to strike price of call • Possibly avoid any out-of-pocket expenditure - If call premium fully finances purchase of put • Retain dividend income and voting rights • Defer capital gains tax	• Forfeit some degree of upside potential - Above call strike • Remain exposed to some price risk - If put strike is set below the current stock price

Structuring Collars: Exchange-Traded Versus Over-The-Counter

- Prior to the financial crisis, exchange-traded options and OTC derivatives traded at approximately the same levels, with perhaps a slight nod going to OTC derivatives.

- Since then, exchange-traded options (including Equity-Flex options) have become somewhat less expensive than OTC derivatives.

- A new hedging dilemma has arisen*:*

  - Is it better for the investor to achieve a slightly better price for the collar by using exchange-traded options (which requires two contracts), but remain subject to the possibility of recognizing phantom income?

  - Or is it better to accept a slightly less robust price for the collar by using an OTC derivative (which can be documented as a single contract), and eliminate the possibility of recognizing phantom income?

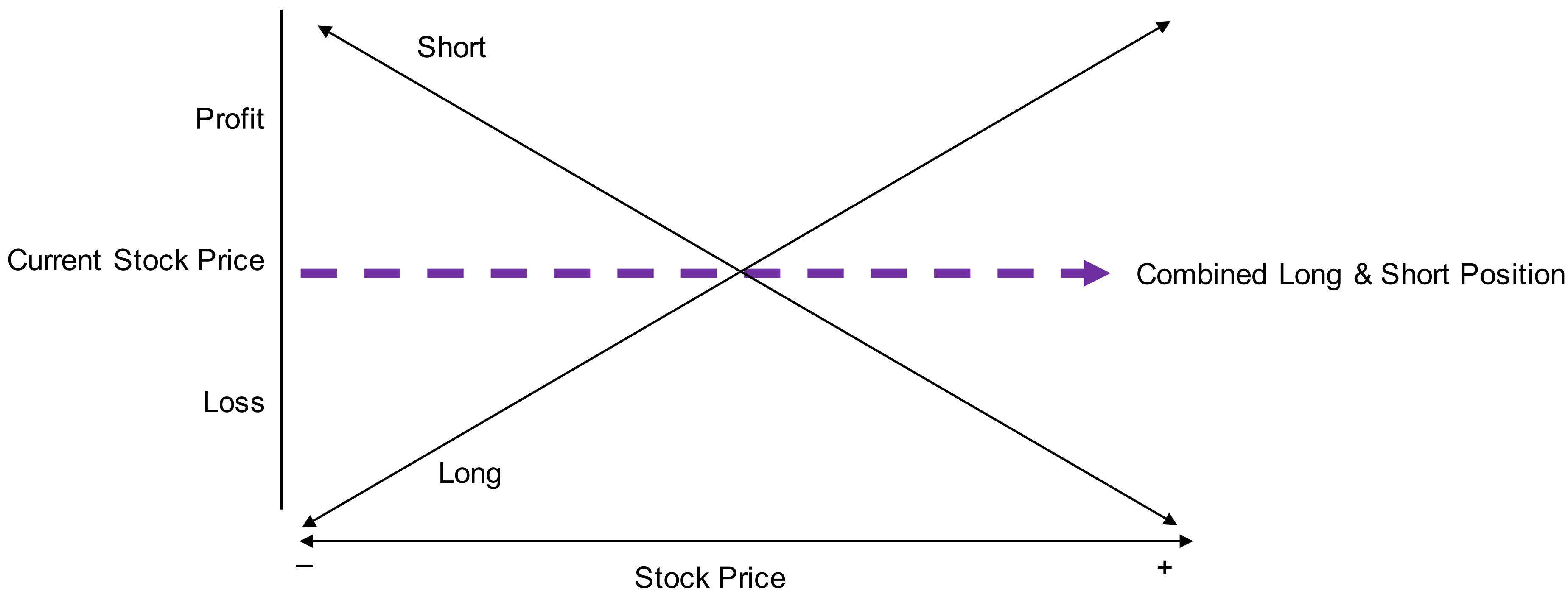
- It's not necessarily an easy decision, and there is no right or wrong answer.

Short Against the Box

1) Long Position

2) Short Position

3) Combined Long and Short Position



Background On Short Against The Box

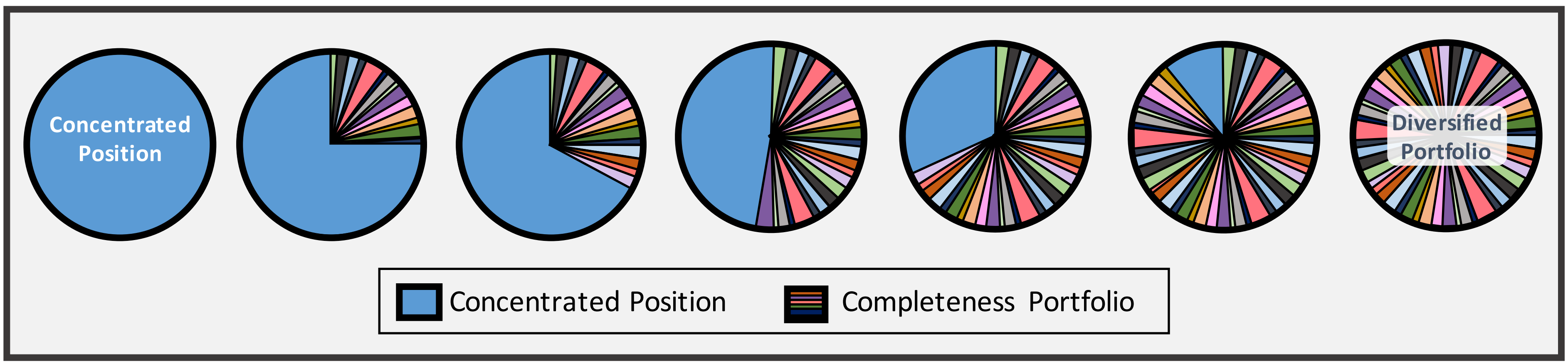
- Form over substance controlled until 1997
- Short against the box (SAB) emerged as the preferred strategy
- Estee Lauder IPO--Giant SAB-drew much publicity/attention to the strategy
- Caused Congress to address
- Taxpayer Relief Act of 1997 greatly curtailed use of SAB and synthetic equivalents
  - Code Sec. 1259: Constructive Sale Rules
- Most investors mistakenly believe SAB is completely prohibited by Sec. 1259
- *SAB is permitted for short-term hedging*
  - Very mechanical tax rules must be followed--no tax ambiguity if executed properly
  - No volatility skew issues as with puts and collars (SAB is a Delta 1 hedge)
  - Hillary v. Trump “Presidential election” hedge last Fall

Longer-Term Protection Strategies

- Completeness Portfolios
- Exchange Funds
- Protection Funds

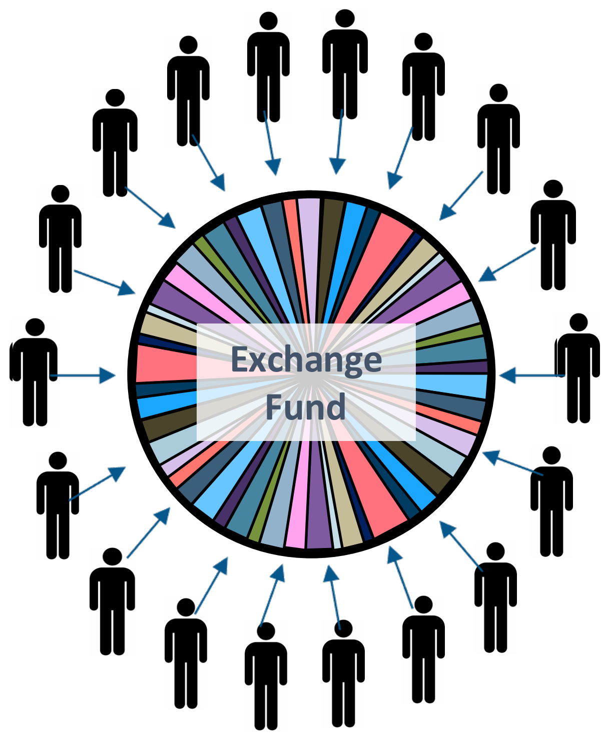
Completeness Portfolios

- Investor starts with a concentrated position in a single publicly traded stock.
- Cash is invested to build a “completeness” portfolio.
- The completeness portfolio incorporates the risk characteristics of the concentrated stock position, such that the combination of the portfolio and concentrated position tracks a broadly diversified market benchmark to the best extent possible.
- As losses are harvested from the completeness portfolio, shares of the concentrated position are sold, without incurring a tax.
- Over time, the size of the concentrated position is gradually whittled down.
- Ultimately, the completeness portfolio becomes an index-tracking one.



Exchange Funds

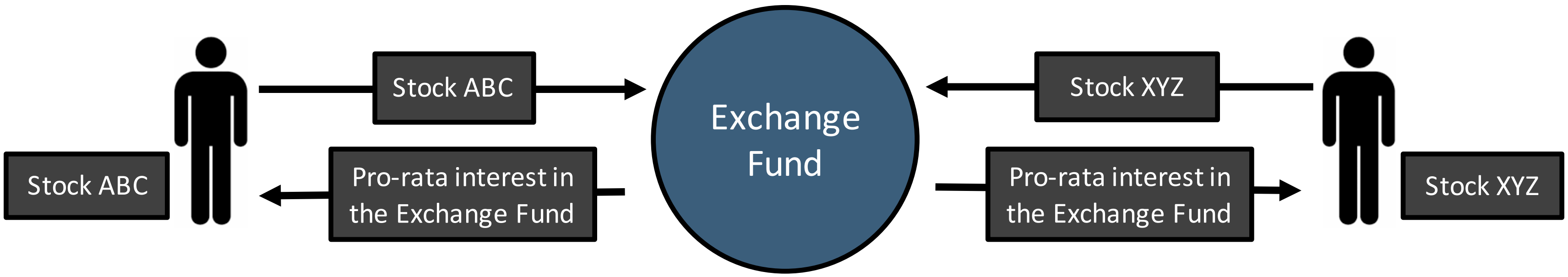
- A partnership or similar entity (i.e., a fund) whose partners each contribute their low-tax-cost-basis shares into the fund in exchange for a pro-rata interest in the fund.



- Useful for investors with highly appreciated stock positions who wish to diversify out of some or all of their position in a tax-deferred manner.

Exchange Funds

Before: Each investor owns shares of stock of different public companies.



After: Each investor owns a pro-rata interest in the fund, which now holds a diversified portfolio of stocks in a variety of industries.

- Contribution of shares to an exchange fund does **not** trigger a taxable event:
  - Tax-cost basis of investor's fund interest = basis of shares he contributed (i.e., a carryover basis)
- Economically, it's as if each investor sold his shares without triggering a taxable event, and immediately reinvested the proceeds into the fund.

Exchange Funds

After 7 years: Investors can redeem their fund interest or remain invested in the fund.

- Upon redemption, an investor receives a basket of securities equal in value to his fund interest, with a carryover basis.
- Redemption does **not** trigger a taxable event. Only upon the *sale* of shares received from the fund, would an investor incur a tax on those shares.

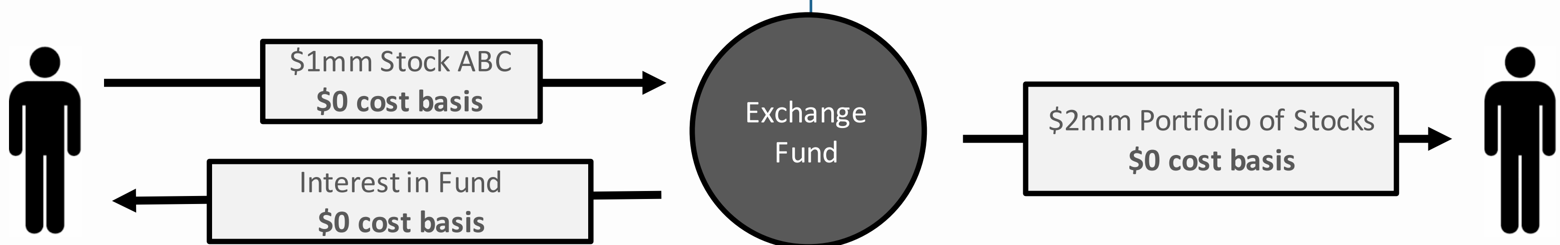
Example

Day 1

- Investor contributes **$1mm** of ABC to Exchange Fund
- Cost basis of ABC shares = **$0**

7 Years Later

- Current value of Ownership Interest = **$2mm**
- Cost basis of Ownership Interest = **$0**



Day 1

- Investor receives an ownership interest in the Fund
  - Current value of Ownership Interest = **$1mm**
  - Cost basis of Ownership Interest = **$0**

7 Years Later

- Investor elects to redeem his fund interest
  - Investor receives a portfolio of stocks worth **$2mm**
  - Cost basis of stocks received = **$0**

Exchange Funds

What if an investor dies while invested in an exchange fund?

- The estate or beneficiary of the decedent receives the fund interest with a stepped-up tax-cost-basis.
- If it subsequently redeems its fund interest, it will receive a portfolio of securities that have the same basis that the fund interest had (i.e., stepped up to fair market value).

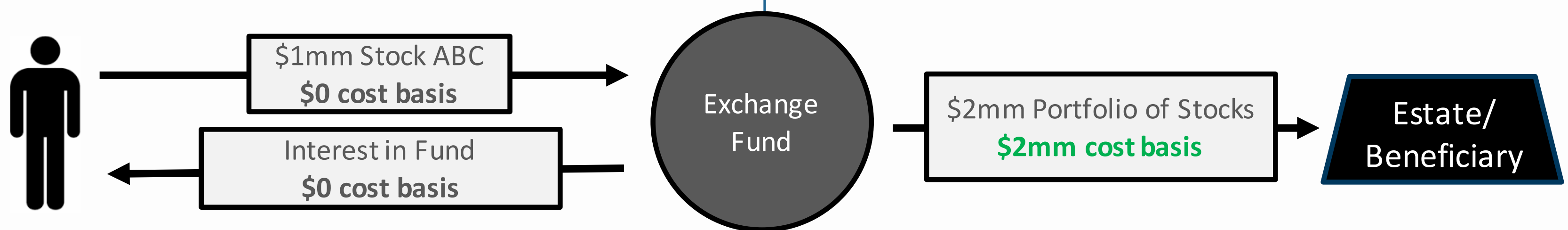
Example

Day 1

- Investor contributes **$1mm** of ABC to Exchange Fund
- Cost basis of ABC shares = **$0**

7 Years Later – Investor Deceased

- Current value of Ownership Interest = **$2mm**
- Cost basis of Ownership Interest = **$2mm**



Day 1

- Investor receives an ownership interest in the Fund
  - Current value of Ownership Interest = **$1mm**
  - Cost basis of Ownership Interest = **$0**

7 Years Later – Investor Deceased

- Estate/Beneficiary elects to redeem its fund interest
  - E/B receives a portfolio of stocks worth **$2mm**
  - Cost basis of stocks received = **$2mm**

Exchange Funds

- **Code Section 721:** Authorizes the transfer of a single, concentrated asset with a low tax-cost-basis to a much larger portfolio of diversified assets, while deferring any capital gains taxes until those diversified assets are eventually sold by the contributor.
- Caveat: No more than 80% of the fund's assets can consist of stocks and securities (and certain other enumerated assets treated as stocks and securities)
- Thus, most exchange fund sponsors make various forms of commercial real estate investments, which are typically funded through debt.

Example: An exchange fund that accepts $1 billion of publicly traded stock might also have illiquid real estate holdings of $250 million, which were funded through a $250 million loan against the fund's $1.25 billion of assets.

- Investors with heavy real estate exposure (such as senior executives of publicly-traded REITS) should consider this factor in their decision-making process.

Exchange Funds

- Exchange funds may not be around forever: Congress has made several attempts to limit their use in the past, and with the possibility of tax reform "in the air," there is a risk that exchange funds could be viewed as a potential "revenue raiser."
- Therefore, investors who are considering an exchange fund investment may wish to do so expeditiously, given that exchange funds could be viewed as a "loophole" to be closed in any tax reform legislation.
- Below are a few articles for those who would like to learn more about exchange funds:
    - David J. Herzig, Am I the Only Person Paying Taxes? The Largest Tax Loophole for the Rich - Exchange Funds, 2009 Mich. St. L. Rev. 538-539.
    - Monte A. Jackel & James B. Sowell, Transfers to Investment Corporations: Complexity in a Conundrum, TAX NOTES at 1664 (2002).
    - See Chirelstein, Marvin A., "Tax Pooling and Tax Postponement--The Capital Exchange Funds" (1965). Faculty Scholarship Series. Paper 4775 (The Yale Journal, Vol.75, Dec. 1965, No. 2).

Introduction To Protection Funds

- **What is a Protection Fund?**
  - New, low-cost risk management solution for investors who own concentrated single-stock positions – such as HNW individuals, wealthy families, corporate executives, trusts, and private companies that were sold in exchange for publicly-traded stock
  - "Non-traditional" approach based on the time-tested principles of both modern portfolio theory and risk pooling/insurance
  - Fundamentally transforms risk by enabling investors to diversify or "mutualize" – and therefore substantially reduce or potentially eliminate – a stock's downside risk, while retaining its full upside potential and all dividend income
- Protection Funds share some similarities with exchange funds
  - Investors who utilize a Protection Fund want to continue to own (and not dispose of) some or all of their stock position as a core, long-term holding
  - Each investor contributes a modest amount of cash (not their shares, which they can keep) into a cash pool that's used to protect the participants from a large decrease in the value of their stock after a period of years

Why Protection Funds Work

MODERN PORTFOLIO THEORY (MPT) tells us that over time there is substantial dispersion in individual stock performance…

Diversification

20 Different Stocks
in
20 Different Industries

Some "Outperform" – Achieving Large Gains

Most Perform "In Line" With Market

Some "Underperform" – Losing Substantial Value

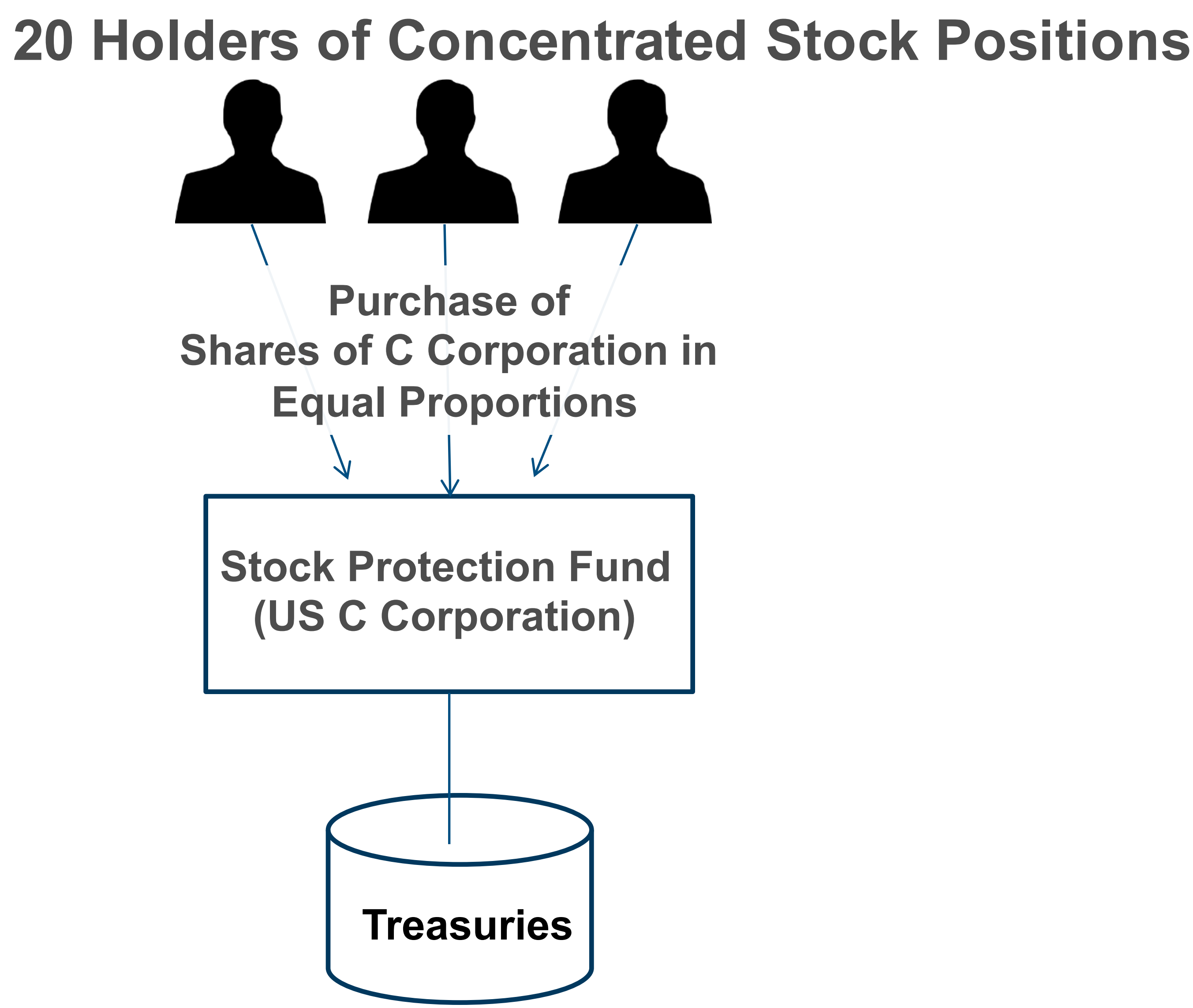
- Different stocks in different industries perform very differently
- It's impossible to predict the performance/outcome for a particular stock
- In a world of huge uncertainty and bubbles, the only certainty is that diversification is the best defense in managing/mitigating downside risk

RISK POOLING spreads similar financial risk evenly among the participants in a self-funded plan designed to protect against catastrophic loss

- Any one investor who sets aside cash lacks the powerful benefit of risk mutualization
- If you set aside cash yourself, in the event of loss, only your money is available to reduce your loss
- In a risk pool, the combined pool of deposits from all contributors is available to reimburse losses

COMBINING THE POWERFUL PROPERTIES OF MPT AND RISK POOLING PROVIDES A LOW-COST RISK MITIGATION SOLUTION FOR CONCENTRATED STOCK OWNERS

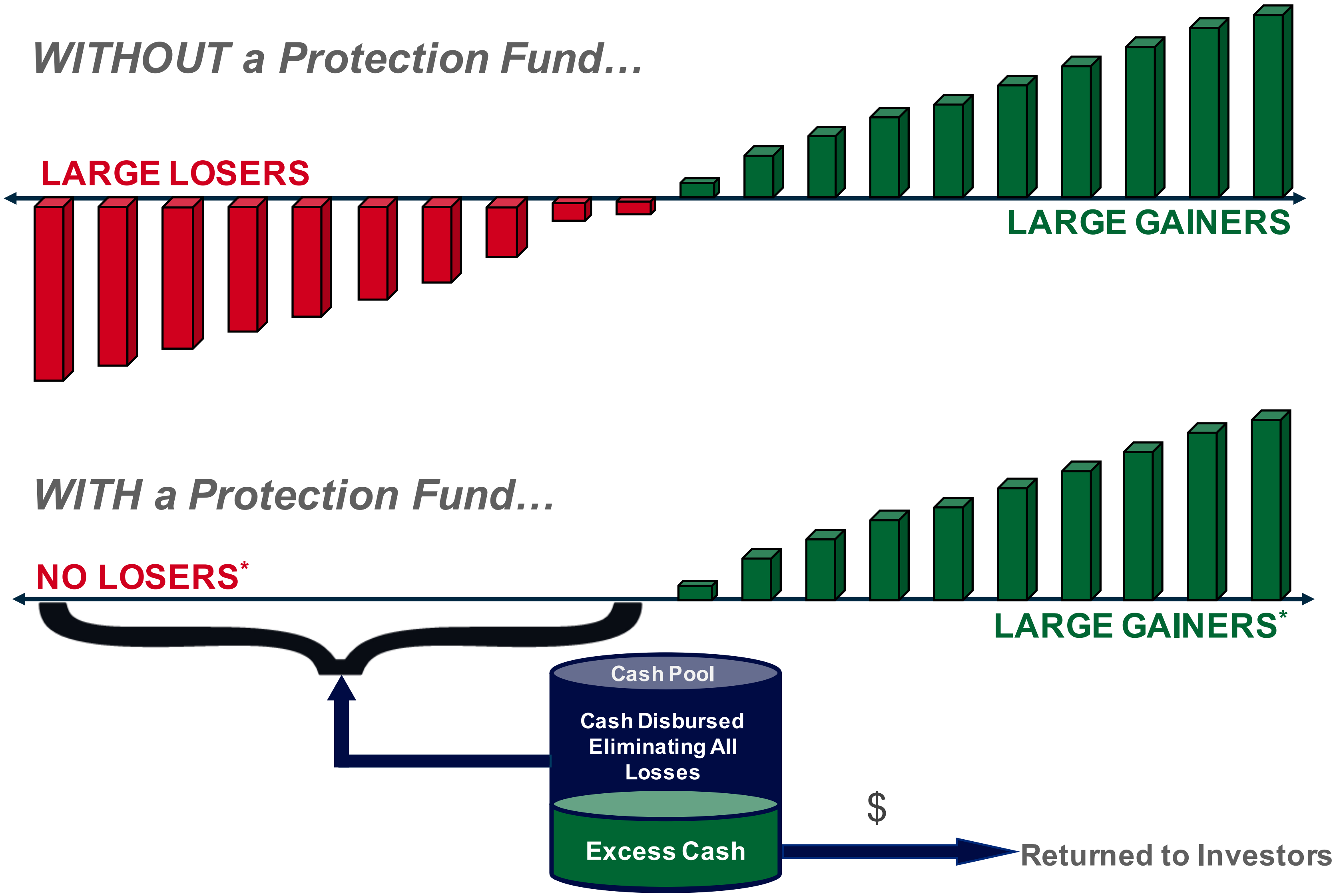
Overview of the Structure



Protection Funds

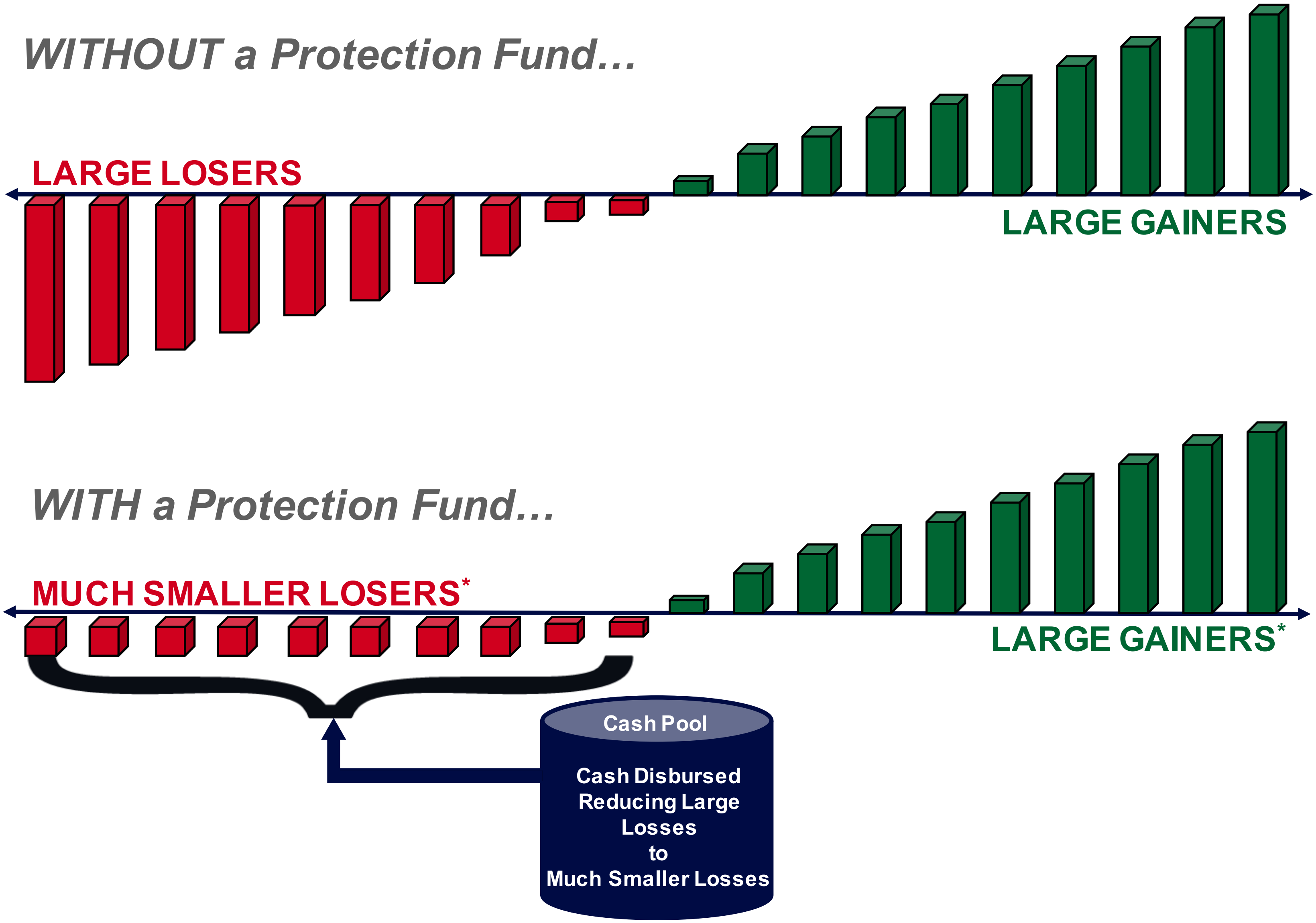
- The **pool of cash** is provided by 20 investors – each with a different stock in a different industry and each looking to protect the same amount of stock:
  - Each investor contributes cash (not stock) equal to 2% of the value of stock being protected per annum for 5 years, which is paid up-front
  - The pool of cash is invested to maturity (i.e. for 5-years) in U.S. Government bonds with a 5-year duration
  - The stock being protected is not touched (not pledged nor subjected to any "lock-up" provision)
- **At maturity, the cash pool is distributed to investors whose stock lost value on a "total return" basis**
- Losses are paid until the cash pool is depleted using a "reverse waterfall" methodology:
  - If the cash pool exceeds total stock losses, all losses are eliminated – and the excess cash is returned to the investors
  - If total stock losses exceed the cash pool, large losses are dramatically/substantially reduced
- **At maturity, investors whose stock has appreciated retain their stock's full upside gain**

If Cash Pool Exceeds Stock Losses...



*Gross of Protection Fund fees

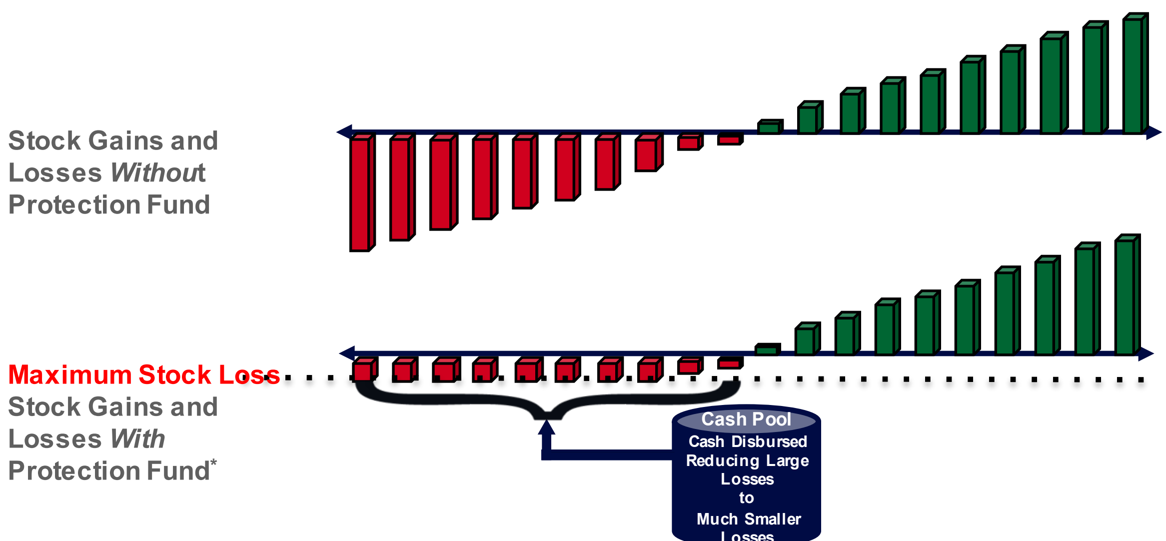
If Stock Losses Exceed Cash Pool…



*Gross of Protection Fund fees

“Maximum Stock Loss” Calculation

- At maturity, calculation of the “Maximum Stock Loss” begins by identifying the **largest** loss incurred among the group of 20 investors’ individual stocks
- Using funds in the cash pool, this loss is reduced (i.e., reimbursed) to the level of the **second-largest** loss incurred among the other 19 stocks
- Next, these two losses are reduced to the level of the **third-largest** loss among the other 18 stocks, and so on
- **This process continues until all losses have been reimbursed or the cash pool is depleted**. The largest remaining loss at this point defines the “Maximum Stock Loss” for all investors incurring losses (stated as a percentage of the initial value of the stock each participant was protecting). The Maximum Stock Loss can be thought of as akin to the strike price of a put option
- For instance, if the “Maximum Stock Loss” was calculated to be 15%, an investor whose stock lost 80% of its value would receive reimbursement from the cash pool reducing his/her loss from 80% to 15%. If the “Maximum Stock Loss” was 0%, the investor’s stock loss of 80% would be fully reimbursed by the cash pool



*Gross of Protection Fund fees

How Protection Funds Work – An Example

Showing a Cash Contribution of 2% per annum or $0.5 Million Paid Up-Front by 20 Investors – Each Protecting a $5 Million Stock Position for 5 Years
…Resulting in a Maximum Stock Loss of 0% (i.e. All Losses are Fully Reimbursed by the Cash Pool)*

INITIALLY (DAY 1)

20 Investors with 20 Different Stocks In 20 Different Industries		
Investor	Stock Protected	10% Cash Contribution
1	$5M	$0.5M
2	$5M	$0.5M
3	$5M	$0.5M
4	$5M	$0.5M
5	$5M	$0.5M
6	$5M	$0.5M
7	$5M	$0.5M
8	$5M	$0.5M
9	$5M	$0.5M
10	$5M	$0.5M
⋮	⋮	⋮
20	$5M	$0.5M
TOTAL	$100M	$10M

Day 1

Cash Pool

$10M
(20 X $0.5M)

After 5 Years

Cash Pool

Payout for Losses: $7.5M

Payout of Excess Cash: $2.5M

AFTER 5 YEARS

**Investor	Without a Protection Fund		With a Protection Fund		
	Stock's Total Return		***Total Payout		Total Payout + Stock Value
	%	$	Loss	Excess Cash	
1	-50%	-2.5M	$2.5M	--	$5M
2	+140%	+7.0M	--	0.167M	$12.167M
3	-20%	-1.0M	$1.0M	--	$5M
4	-30%	-1.5M	$1.5M	--	$5M
5	+60%	+3.0M	--	0.167M	$8.167M
6	+20%	+1.0M	--	0.167M	$6.167M
7	-10%	-0.5M	$0.5M	--	$5M
8	+180%	+9.0M	--	0.167M	$14.167M
9	+70%	+3.5M	--	0.167M	$8.667M
10	+10%	+0.5M	--	0.167M	$5.667M
⋮	⋮	⋮	⋮	⋮	⋮
20	-40%	-2.0M	$2.0M	--	$5M
			$7.5M	$2.5M	

Cash Pool Pays Stock Losses

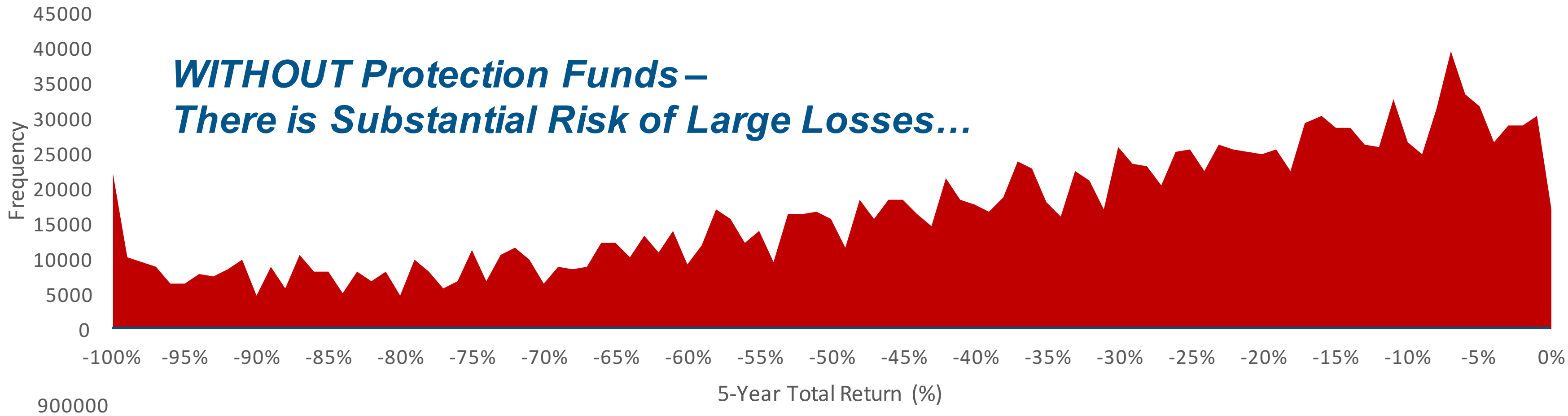
Excess Cash Divided Among Those Who Did Not Incur a Loss

* Gross of Protection Fund fees
**Assumes Investors 11-19 have positive total returns
***Assumes the annual cost of operating the Protection Fund is fully paid for by the interest income generated by the Cash Pool

Backtesting Results

Historical Backtesting from December 31, 1972, to December 31, 2016 –
Cash Contribution of 2% per year (payable up-front) of the Protected Stock Position for a Term of 5 Years

Based on 8 million data points – 400,000 random computer simulations using 1972 - 2016 S&P 500 database
(10,000 simulations per 5-year period and 20 stocks per simulation)



Backtesting uses historical market data in an effort to model historical performance and confirm value of a particular strategy.
The results above are NOT actual results. Actual results could differ significantly from the theoretical results presented.

*Gross of Protection Fund fees

Exchanging vs. Protecting Shares

- Pool Shares to Diversify Out of Them Entirely; Pool Cash to Diversify Downside Risk Only

Exchange Fund

- **Dispose** of concentrated position
- **Pool shares** with other investors who wish to exit from their concentrated positions
- **Exchange shares** for a pro-rata ownership interest in the Fund
- **Diversify** into a portfolio with upside potential
- **Shares are locked-up** for 7 years for tax purposes

Diversify Downside Risk

Protection Fund

- **Remain invested** in concentrated position
- **Pool cash** with other investors who wish to preserve the value of their concentrated positions
- **Protect** against a decline in the value of investors' concentrated positions by mutualizing their downside risk
- **Retain 100% upside potential** of stock incl. all future appreciation and dividends
- **Shares can be sold anytime** as they are unencumbered (only cash contribution is "locked up" for term of the Fund)

Exchanging vs. Protecting Shares

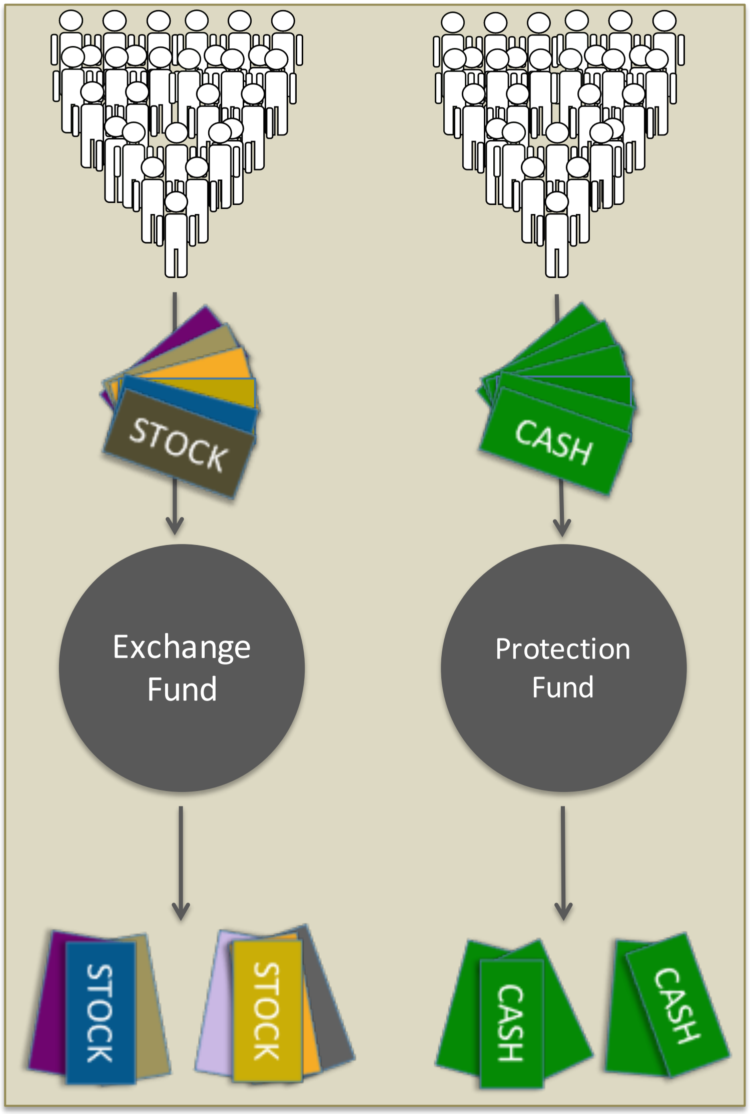
- Pool Shares to Diversify Out of Them Entirely; Pool Cash to Diversify Downside Risk Only

Exchange Funds

- A diverse group of investors with concentrated stock positions each contributes his/her shares in exchange for an ownership interest in the fund proportionate to the value of the shares he/she contributed.

- Upon leaving the exchange fund (after a minimum of 7 years), each investor receives a diverse basket of individual stocks.

Result: Tax-Efficient Diversification



Protection Funds

- A diverse group of investors with concentrated stock positions each contribute a cash "premium" in exchange for an ownership interest in the Fund.

- The cash pool is managed conservatively for the term of the Fund, after which time it is used to reimburse investors whose positions have incurred losses (on a total return basis).

- Excess cash is returned to investors, beginning with those who did not need a reimbursement.

Result: Affordable Downside Protection

Federal Income Tax Issues Posed by a Stock Protection Fund Transaction

No Common Law Constructive Sale

- A promise to bear loss or the right to share appreciation, in and of itself, does not trigger a common law constructive sale.

- Tax ownership requires more than exposure to the economics of property.

- Other rights indicating ownership include the right to vote the securities, sell the securities and receive information from the issuer.

- Code § 1260, Miami Nat'l Bank, North Texas Lumber, Short sale rules, Bourne & Modesto.

No Statutory Constructive Sale

- Code § 1259 provides that if a taxpayer enters into certain offsetting positions, gain is triggered in the original position.
- Applies to "appreciated financial positions." These include positions in stock & partnership interests if gain would be recognized if the position were sold.
- Forward contracts to sell stock are constructive sales only if contract requires delivery of a substantially fixed amount of property.

More on Statutory Constructive Sales

- A contract with a "significant" variation in the amount of property to be delivered is not a constructive sale.
- Constructive sales must deprive the owner of opportunity for gain as well as risk of loss.
- Stock Protection Fund is akin to the purchase of a put option.
- Other constructive sale transactions include:
  - Short sales
  - Offsetting swap transactions
  - Other transactions with substantially the same effect

What is a Tax Straddle?

- A straddle exists when a taxpayer has “offsetting positions” with respect to “personal property.”
- Offsetting positions exist when “there is a substantial diminution of risk of loss” from holding one position by reason of holding one or more other positions.
- No specific level of risk reduction is specified by the statute.
- In contrast to the wash sale rules, the 2 positions do not have to be substantial identical.
- Straddles can arise from inventory hedging transactions, managing interest rate risk from Treasury operations & defeasing risk from supplies

What Are the Consequences of a Straddle?

- If the capital gain long-term holding period for a position that is included in a straddle is not met, the holding period is reset to zero.

- Losses on a leg of a straddle are deferred to the extent of unrecognized gain in the other leg of the straddle.

- At the end of each succeeding taxable year, the unrecognized gain is recomputed. To the extent that the unrecognized gain is less than the unallowed loss, the loss is recognized.

- Net interest and carrying charges incurred with respect to a straddle are capitalized. The amount subject to capitalization is reduced by current income on the straddle positions. These amounts are referred to "qualified income offsets."

Basket Transactions & Straddles

- The dividend received deduction (DRD) rules contain a substantially similar standard to the straddle rules. No DRD is permitted if the taxpayer has diminished his risk of loss by holding an offsetting position.
- The DRD rules contain special rules for basket transactions.
- If the basket contains 20 or more positions, risk of loss is not considered diminished unless there is a substantial overlap with the taxpayer's holdings.
- Substantial overlap is considered to exist if the overlap is 70% or more.
- The Stock Protection Fund should not have a substantial overlap because there should only be a 5% overlap.

Anti-Abuse Rule for Basket Transactions

- Even if there is no substantial overlap, a basket transaction can constitute an offsetting position if:
- Changes in the value of the position are reasonably expected to track changes in value of stock holdings and
- Principal purpose is to obtain tax savings
- Diminution of market risk does not create an offset.
- Stock Protection Fund should be eligible for the basket rule when there are 20 investors.
- In addition, there is no guarantee of a pay-out if there is a loss. Positions that have experienced greater losses may absorb the pool of cash.

Qualified Dividend Income

- Dividends are taxed at long-term capital gain rates if the dividend is a qualified dividend (QDI).
- A dividend cannot be QDI if the holder has diminished his risk loss during the 121-day period that begins 60 days before the dividend.
- Same principles that apply to straddles should apply to determine whether the taxpayer has diminished his risk of loss for QDI purposes.
- The principles of the basket rules should apply so that the investor has not diminished his risk of loss.

Other Tax Issues

- Gain on a Stock Protection Fund certificate redemption should be treated as capital gain. The gain will be long-term capital gain if the certificate has been held for more than one year. Loss should be currently deductible.

- If stock being protected is under an incentive stock option grant, the stock protection fund should not be treated as a disqualifying disposition.

- If an investor borrows against the stock being protected to fund his purchase of a stock protection fund certificate, the interest expense paid on the borrowing should be currently deductible against investment income.

Summary of Benefits – Protection Funds

- **Cost-effective**
  - Affordability enables investors to embrace a long-term, strategic approach to mitigating their stock's specific company risk while retaining 100% of its appreciation and all dividends*
- **Tax-efficient**
- **Shares can be sold anytime**
  - Shares are not pledged nor subjected to liens/security interests of any kind and therefore can be sold by the investor anytime during the term of the Protection Fund
- **Shares can be held in custody wherever each shareholder chooses**
- **Simple to use, easy to understand, and completely transparent (i.e. daily mark to market)**
- **Potentially Cashless**
  - Investors can borrow against their shares to fund their modest contribution to the Fund
  - Investors can write covered calls to help fund the modest cash contributions
- **No dealer counterparty credit risk**
  - Investors retain the capacity to comfortably take on the credit risk inherent in other desirable structured products without "overdoing it"

*Gross of Protection Fund fees

Summary of Strategies Discussed Today

	Outright Sale	Put Options	Covered Calls	Collars	Exchange Funds	Protection Funds
Ideal Time Horizon	Short-Term	Short-Term (6-18months)	Short-Term (6-18months)	Short-Term (6-18months)	Long-Term (7+ years)	Long-Term (5+ years)
Reduce Downside Risk	✓	✓	To the extent of premium received	✓	✓	✓
Keep 100% of Stock's Upside	x	✓	x	x	x	✓
Diversify Upside	x	x	x	x	✓	x
Provide Liquidity	✓	x	To the extent of premium received	x	x	x
Able to Sell Shares Any Time	n/a	✓	✓ *	x	x	✓
Does **Not** Trigger a Reportable Event	x	x	x	x	x	✓
Might Be Appropriate for Investors seeking…	Immediate liquidity, elimination of downside risk, and ability to diversify upside	Short-term downside protection, without capping upside	Additional income, some downside protection, and potentially some diversification over time	Short-term downside protection; willing to cap upside to reduce cost	Diversification	Long-term downside protection, without capping upside

*Investor can sell shares at any time, but will need to be prepared to cash settle if call option is exercised after shares have been sold.


Q&A

Tom Boczar
Chief Executive Officer
Intelligent Edge Securities, LLC
tboczar@intelligent-edge.com

Mark Leeds
Mayer Brown
Tax Partner
mleeds@mayerbrown.com

Brian Yolles
Chief Executive Officer
StockShield, LLC
Brian.Yolles@stockshield.com

Elizabeth Ostrander
Head of Business Development
Intelligent Edge Securities, LLC
eostrander@intelligent-edge.com