Hedging and Liquidity Strategies for Concentrated Stock Positions

Introduction

• Does a single investment dominate your portfolio?
• Did you sell your business and receive shares of the acquirer?
• Have you received a significant portion of your compensation in company stock or options?

With the growth in stock-for-stock acquisitions, initial public offerings and the US equity markets, many investors are faced with the challenge of managing the risks associated with low cost basis and restricted stock holdings (generally referred to as “concentrated equity positions”). Holders of concentrated equity positions may often neglect to hedge or diversify their exposure due to a sense of loyalty to a stock that has performed well in the past, or to a company in which the investors have a controlling relationship. As a result, investors may be overexposed to unexpected company and market events, economic cycles and tax liabilities during cash flow “crunch” times. This publication aims to describe strategies that may enable investors of concentrated stock positions to:

Preserve capital by providing protection against a decrease in the value of a stock;

Generate liquidity or “monetize” the value of a stock position;

Diversify the exposure from a single stock holding to another asset; and/or

Defer the capital gains tax associated with an outright sale of the securities.

PRIVATE MARKET STRATEGIES

The strategies detailed in this publication that involve the purchase or sale of an equity option can be created by utilizing listed or over-the-counter equity options (“OTC” options). Options listed on an exchange (“listed options”), such as the Chicago Board Options Exchange, generally have predetermined strike prices, expirations, exercise features and settlement features. OTC options, which are privately negotiated financial instruments and are not traded on an exchange, can be customized to meet an investor’s specific financial objectives. Additional strategies, such as the prepaid forward sale transaction, contingent forward sale and strategies involving the delivery of restricted securities, are unavailable in the public markets and can only be created through private transactions. Due to the greater flexibility of OTC options relative to listed options, this publication assumes each of the referenced strategies is created through private market transactions.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NOT CDIC INSURED • NOT GOVERNMENT INSURED • NO BANK GUARANTEE • MAY LOSE VALUE
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Hedging Strategies

Hedging is used to reduce exposure to risk and help limit investment loss by effecting a transaction (for a cost) which offsets an existing position.

**BUYING A PUT OPTION**

Buying a put option gives the holder or purchaser the right, but not the obligation, to sell the underlying security at a predetermined price (the “put strike price”) on or before a specific date (the “expiration date” or “maturity date”). The purchase of a put option provides protection against downward stock price movements when the option is exercised below the put strike price. The investor continues to participate in any stock price appreciation. A put option strategy is generally valuable to an investor who holds stock with a low cost basis or resale limitations, such as holding period requirements or volume restrictions. The transaction may be structured so that the investor, at expiration, settles the put option in cash or delivers the underlying shares. (Please see Appendix F for the definitions of Cash and Physical Settlement.)

**Example of a Put Option**

- An investor owns 100,000 shares of stock with a current market price of $50.00.
- The investor seeks to limit downside price exposure but is unwilling to sell the shares due to the tax consequences.
- The investor purchases a two-year, European-style (exercisable only at expiration) put option with a strike price of $45.00 (90% of the current stock price) at a net cost of $3.75 per share.

**Figure 1. Put Option Diagram**

Diagram includes the payment of option premium.

<table>
<thead>
<tr>
<th>Settlement of Put Option at Expiration</th>
<th>Stock Price at Expiration</th>
<th>Cash Settlement</th>
<th>Physical Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$40</td>
<td>Investor receives $5 per share ($45 put strike – $40 stock price)</td>
<td>Investor delivers (sells) 100,000 shares</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Investor retains 100,000 shares</td>
<td>Investor receives $45 per share</td>
</tr>
<tr>
<td></td>
<td>$50</td>
<td>Option expire worthless</td>
<td>Option expires worthless</td>
</tr>
<tr>
<td></td>
<td></td>
<td>No payments</td>
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<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Advantages**

- Stock price protection below the put strike price.
- Participation in stock price appreciation.
- Maintain benefits of stock ownership, including voting rights and dividends.
- Cash settlement may defer a sale of the underlying shares.

**Considerations**

- Out-of-pocket premium to pay for the put option.
- Investor can lose 100% of premium.
- Exposure to stock price movements between the market price and put strike price.
- Investor may incur a cost to terminate the transaction prior to maturity.
- Physical settlement may not be available for options on restricted securities or puts purchased by company insiders.
- Cash settlement may raise Section 16(b) issues for company insiders. (Please see Appendix D for a description of Section 16.)
- Tax and legal considerations. (Please see the Appendices.)

*This example and related diagram are for illustrative purposes only and are not indicative of any investment. Please note that these illustrations do not reflect the impact of any transaction costs or fees, tax implications and related charges which if they had been included may have a significant effect on expected returns and should be considered before engaging in any investment strategy.
Hedging and Liquidity Strategies for Concentrated Stock Positions

SALE OF A CALL OPTION

A call option gives the purchaser or buyer the right, but not the obligation, to buy the underlying security at a predetermined price (the “call strike price”) on or before a specific date (the “expiration date” or “maturity date”). The seller of a call option receives an option premium from the buyer for providing the buyer with the right to buy the underlying stock at the call strike price. By selling a call option and receiving the premium, an investor can increase the yield on an equity position and receive limited downside protection. The investor is, in effect, being compensated today for the decision to sell the stock at a predetermined price in the future. Cash settlement of the call option may defer a sale of the underlying stock. (Please see Appendix F for the definitions of Cash and Physical Settlement.)

Example of a Call Option*

• An investor owns 100,000 shares of stock with a current market price of $50.00.
• The investor wants to generate additional income and is willing to sell the shares if the stock reaches a specific price.
• The investor sells a two-year, European-style (exercisable only at expiration) call option with a strike price of $65.00 (130% of the current stock price) and receives $3.75 per share in option premium.

Figure 2. Sale of a Call Option Diagram

![Figure 2. Sale of a Call Option Diagram](image)

Diagram includes the receipt of option premium.

Settlement of Call Option at Expiration

<table>
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<tr>
<th>Stock Price at Expiration</th>
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<tr>
<td>$50</td>
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</tr>
</tbody>
</table>

Advantages

• Investor receives up-front premium.
• Maintain benefits of stock ownership, including voting rights and dividends.
• Cash settlement may defer a sale of the underlying shares.

Considerations

• Limited downside protection.
• No participation in stock price appreciation above call strike price.
• Investor may incur a cost to terminate the transaction prior to maturity.
• Physical settlement may not be available for options on restricted securities or calls sold by company insiders.
• Cash settlement may raise Section 16(b) issues for company insiders. (Please see Appendix D for a description of Section 16.)
• Collateral may be required for margin and credit purposes.
• Tax and legal considerations. (Please see the Appendices.)

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EQUITY COLLAR

A collar strategy can protect the value of an equity position while still allowing for additional participation in potential upside. A collar is created by purchasing a put option with a strike price at or below the current stock price and selling a call option with a strike price above the current stock price (while simultaneously holding shares of the underlying stock). The value of the equity position is protected below the strike price of the put option. By establishing a collar, a minimum and maximum value is created around an investor’s equity position until the maturity of the options. A collar can be structured so that the premium received from the sale of the call option completely offsets the purchase price of the put option. This type of collar is referred to as a “zero premium collar.” The transaction may also be structured so that the investor, at expiration, may settle the put or call option in cash or by delivering the underlying shares. (Please see Appendix F for the definitions of Cash and Physical Settlement.)

Example of Equity Collar*

- An investor owns 100,000 shares of stock with a current market price of $50.00.
- The investor seeks to limit downside price exposure without paying any net option premium.
- The investor purchases a two-year, European-style (exercisable only at expiration) put option with a strike price of $45.00 (90% of the current stock price) and sells a two-year, European-style call option with a strike price of $65.00 (130% of the current stock price).
- The premium received from the sale of the call option completely offsets the purchase price of the put option.

Figure 3. Collar Diagram

<table>
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<tr>
<td></td>
<td>Investor retains 100,000 shares</td>
<td>Investor receives $65 per share</td>
</tr>
</tbody>
</table>

Advantages

- Additional upside price participation in the stock up to the call strike price.
- Stock price protection below the put strike price.
- Reduced or no initial out-of-pocket premium.
- Maintain benefits of stock ownership, including voting rights and dividends.
- Cash settlement may defer a sale of the underlying shares.

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Considerations

- Exposure to stock price movements between the market price and put strike price.
- No participation in stock price appreciation above call strike price.
- Investor may incur a cost to terminate the transaction prior to maturity.
- Physical settlement may not be available for options on restricted securities or collars with company insiders. Cash Settlement may raise Section 16(b) issues for company insiders. (Please see below “Special considerations for company insiders.”)
- Collateral may be required for margin and credit purposes.
- Tax and legal considerations. (Please see the Appendices.)

Special Considerations for Company Insiders

Collar transactions may raise issues for company insiders under Section 16(b) of the Securities Exchange Act of 1934 (please see Appendix D for a description of Section 16). Generally, collar transactions can be settled at expiration by delivering freely tradable stock (physical settlement) or electing cash settlement. Since company insiders own control securities, subject to Rule 144 under the Securities Act of 1933, collar transactions should be cash-settled. Cash settlement, however, can create unfavorable Section 16(b) implications if the company insider sells company stock within six months of the expiration or termination of a collar.

To address this cash settlement issue, a hedging strategy referred to as a “range forward sale” has been created specifically for company insiders. The range forward sale, which is economically similar to a collar, can be settled at expiration by delivering the underlying stock. By physically settling the transaction, the company insider can eliminate the Section 16(b) issues associated with cash settlement.

Similar to a collar, a range forward sale creates a minimum and maximum sale price for the underlying stock. Unlike a collar, if the stock price at expiration is in between the minimum and maximum sale price, the company insider will sell the underlying stock at the stock price at expiration.
Hedging and Liquidity Strategies

**MARGIN LOAN**

Hedging strategies can be combined with margin loans to provide investors with liquidity for securities investment or personal use. Loans combined with hedging strategies (put option or a collar) generally have higher loan values than standard margin loans due to reduced credit and market risk. Margin loans are subject to either Federal Reserve Board Regulation T or Regulation U and must be classified as either purpose loans or nonpurpose loans. The proceeds of purpose loans can be reinvested into securities, whereas proceeds of nonpurpose loans cannot be reinvested into securities. Under Regulation T or Regulation U, a lender may only lend up to 50% of the market value of an equity position for purpose loans. The prepaid forward sale transaction provides a more flexible alternative.

**PREPAID FORWARD SALE TRANSACTION**

A prepaid forward sale transaction allows investors to hedge and generate significant liquidity from an equity position while deferring taxes until the expiration of the contract.

Similar to an equity collar, a prepaid forward sale transaction provides downside stock price protection and limited upside participation. However, as compared to a collar-plus-loan, a prepaid forward sale transaction can provide investors with flexibility in the reinvestment of proceeds.

In a prepaid forward sale transaction, an investor enters into a forward sale contract with a minimum ("downside protection price") and a maximum ("capped upside participation price") sale price at expiration. After execution, the investor receives a prepayment of the minimum sale price. The prepayment ("initial proceeds") is discounted to reflect the present value of the future minimum sale price and adjusted based on where the downside protection price and capped upside participation price are set. At expiration, if the share price is below the downside protection price, the investor will deliver 100% of the shares underlying the prepaid forward sale transaction. If the share price is above the downside protection price, the investor will keep some of the upside by retaining a portion of the shares underlying the prepaid forward sale transaction. Alternatively, it may be possible to cash settle the prepaid forward sale transaction.

**Example of Prepaid Forward Sale Transaction***

- An investor owns 100,000 shares of stock with a current market price of $50.00.
- The investor seeks to limit downside price exposure and generate liquidity for reinvestment without selling stock.
- The investor enters into a two-year prepaid forward sale transaction. The transaction has a downside protection price ("DPP") of $45.00 (90.00% of the current price) and a capped upside participation price ("CUPP") of $65.00 (130.00% of the current price). After execution, the investor receives $40.05 per share or 80.10% of current market value. This represents a discount rate of 6% per annum from the DPP.

**Figure 4. Prepaid Forward Sale Diagram**

- The investor has flexibility in reinvesting the proceeds. At expiration, the investor will deliver all 100,000 shares if the stock price at maturity is less than the DPP. If the stock price at maturity is equal to or greater than the DPP, the investor will deliver shares with a value (based on the stock price at maturity) equal to 100,000 times the sum of the DPP of $45.00 plus any excess of the stock price at maturity over the CUPP of $65.00.

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### Settlement of Prepaid Forward Sale at Expiration

<table>
<thead>
<tr>
<th>Stock Price at Expiration</th>
<th>Cash Settlement</th>
<th>Physical Settlement</th>
</tr>
</thead>
</table>
| $40                       | • Investor pays value of shares it would otherwise deliver of $4 million (100,000 shares times $40 current stock price) | • Investor delivers 100,000 shares worth $40 per share  
• Investor does not retain any shares |
| $50                       | • Investor pays value of shares it would otherwise deliver of $4.5 million (90,000 shares times $50 current stock price) | • Investor delivers 90,000 shares ($45 DPP/$50 current stock price)  
• Investor retains 10,000 shares |
| $70                       | • Investor pays value of shares it would otherwise deliver of $5 million (71,429 shares times $70 current stock price) | • Investor delivers 71,429 shares ($45 DPP + $70 current stock price - $65 CUPP/$70 current stock price)  
• Investor retains 28,571 shares |

### Considerations
- Exposure to stock price movements between the market price and the downside protection price.
- No participation in stock price appreciation above the capped upside participation price.
- Investor may incur a cost to terminate the transaction prior to maturity.
- Investor must pledge all of the underlying shares as collateral.
- Transactions by company insiders require compliance with Rule 144 under the Securities Act.
- Cash settlement may raise Section 16(b) issues for company insiders. (Please see Appendix D for a description of Section 16.)
- Tax and legal considerations (Please see the Appendices).

### Advantages
- Additional upside price participation in the stock up to the capped upside participation price.
- Stock price protection below the downside protection price.
- Relative to a purpose margin loan, investor monetizes a greater percentage of an equity holding.
- All proceeds can be reinvested into marketable securities.
- Maintain benefits of stock ownership, including voting rights and dividends.
- Cash settlement may defer a sale of the underlying shares. (Investor must be eligible for cash settlement. Please see Appendix E.)
CONTINGENT FORWARD SALE

The contingent forward sale was developed to allow an investor with concentrated stock positions the opportunity to lock in the stock price over time at a premium to the investor's target price. In a contingent forward sale, an investor enters into a contract to sell for future settlement a predetermined number of shares each trading day over a defined period of time. The investor will agree to sell shares, each trading day, if the closing stock price is greater than the predetermined stock price (referred to as the "contingent price"). If the closing stock price is equal to or less than the contingent price, no shares will be sold. The sale price for the shares will be a predetermined premium to the contingent price (referred to as the "forward sale price"). On the expiration date of the contract, the investor will deliver the shares and receive the sale proceeds. Periodic settlement may also be available during the life of the contract.

Example of Contingent Forward Sale*

- The investor wants to lock in the selling price for 1,000 shares each trading day that the stock closes above the current stock price of $40.00 per share (contingent price is 100% of current stock price).
- An investor enters into a contingent forward sale contract to sell 1,000 shares each trading day over the next 250 trading days or one year (250,000 share total contract size).
- If the stock price closes above the trigger price, a forward sale will occur for 1,000 shares and the investor will receive the forward sale price of $48.00 per share (120% of the current stock price) on the agreed upon date.
- If the closing stock price on any trading day is equal to or less than $40.00 per share trigger price, no forward sale occurs and 1,000 shares will be retained by the investor.
- Either periodically or at expiration of the contract, the investor will deliver the shares that became subject to the forward contract and receive the sale proceeds for those shares.

Advantages

- Investor has the opportunity to sell stock at a premium to the target sale price.
- Maintain benefits of stock ownership, including voting rights and dividends.

Considerations

- Maximum sale price to investor is the forward sale price.
- No shares are sold if the stock closes below the contingent price.
- Investor may incur a cost to terminate the transaction prior to maturity.
- Legal considerations. (Please see the Appendices.)
- There is no specific guidance on the tax treatment of these contingent forward sale contracts, and thus you are urged to consult with your tax advisor. It is possible that for tax purposes, a contingent forward sale contract could be viewed as the investor entering into a series of options to sell the stock on a forward basis at maturity of such contract, with a portion of options exercisable on each trading day during the year if the stock closes above the trigger price on such trading day. Generally, option transactions are not taxed until the maturity of the contract. However, the IRS may take the position that each day in which the stock closes above the trigger price is a taxable event with respect to the number of shares underlying the contract for that day.
- For background purposes, please see Appendix for discussion of tax considerations related to the sale of options and prepaid forward sales.

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EMPLOYEE STOCK OPTION CONSIDERATIONS

Many companies grant employee stock options as a means to compensate and motivate key employees. Employee stock options give the holder the right to buy the company stock at a specified price after a specified vesting period. The two main types of employee stock options are: (1) incentive stock options (“ISOs”) and (2) nonqualified stock options (“NQSOs”). While hedging strategies can limit an investor’s downward price exposure in the underlying stock, there are important considerations, such as margin requirements, the economic exposure of uncovered option sales and tax considerations.

Uncovered Call Writing

Employee stock options are generally not transferable and do not have margin value. Therefore, investors hedging employee stock options by selling equity options, such as call options, are required to post other acceptable collateral to meet the margin requirements. The investor’s exposure will increase as the stock price appreciates. Additionally, if the investor sells call options and terminates employment, the investor may lose the employee stock options. This risk can be reduced if the employee owns vested stock options that are exercisable without restrictions or holds the underlying stock through a previous employee stock option exercise.

TAX CONSIDERATIONS

A holder of an NQSO is subject to tax at ordinary rates, at the time of option exercise, on the difference between the fair market value of the stock and the exercise price of the option. The holder’s tax basis in the stock is equal to the fair market value of the stock on the exercise date.

The US Internal Revenue Service has not yet ruled on the tax treatment of employees hedging their NQSOs. Generally, losses for qualified hedging transactions are treated as ordinary losses that should be available to offset income from the exercise of NQSOs. However, capital losses generated from transactions that do not qualify as hedging transactions, such as speculative call option sales or collars hedging capital gain stock, may not offset the recognition of ordinary income from the exercise of the NQSO. Given the existing tax uncertainty and the potential for significant mismatches in ordinary income and non-deductible capital losses if the transaction does not qualify as a hedging transaction, investors are urged to consult their tax advisors before hedging NQSOs.

A holder of ISOs does not incur a taxable event in the year that an ISO is exercised. However, the difference between the fair market value of the stock and the exercise price is treated as an alternative minimum tax (“AMT”) adjustment in the year of exercise. The holder normally will be taxed at capital gains rates when the stock is sold based upon the difference between the selling price of the stock and the ISO exercise price, as long as the sale of the stock does not constitute a “disqualifying disposition.” A disqualifying disposition occurs if the ISO stock is disposed of before the expiration of two years from the date the ISO was granted and one year from the date the ISO was exercised.

This is known as the ISO holding period. If the underlying stock is not hedged at the time of exercise or at any time during the one-year period following the exercise date, the investor’s holding period in the stock for capital gains purposes will begin on the exercise date, and any sale of the stock more than one year after the exercise date will result in long-term capital gain or loss. In general, it is unclear whether entering into a hedge of an ISO or ISO stock should terminate or otherwise adversely affect the ISO holding period and, therefore, investors should consult their own tax advisors before hedging an ISO or ISO stock. The major tax considerations regarding hedges of NQSOs or ISOs are the: (1) straddle holding period and loss deferral rules; (2) short sale holding period rules; (3) the constructive sale rules; and (4) potential mismatching of ordinary income from the exercise of an NQSO or ISO (if there has been a “disqualifying disposition” of the ISO) and a capital loss from the hedging transaction.
Appendix

APPENDIX A: US TAX CONSIDERATIONS

This section provides a general overview of the US tax considerations surrounding equity derivative transactions such as those described in this publication and does not represent tax or accounting advice. Each subject can subsume substantial complexities and details that may not be addressed in this publication. This publication also discusses the tax environment as of the date of this publication and does not take into account any possible changes in the law which, if adopted, could affect the utility of the strategies described. Please consult with your tax and accounting advisors prior to considering any equity derivative transaction.

Tax Disclosures

Notwithstanding any other provision in this publication, you and Citigroup hereby agree that you (and each employee, representative or other agent of the investor) may disclose to any and all persons, without limitation of any kind, the US tax treatment and US tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to you relating to such US tax treatment and US tax structure, other than any information for which nondisclosure is reasonably necessary in order to comply with applicable securities laws.

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Certain Tax Considerations related to the Purchase of Put Option

Constructive Sale

A put option should not result in a constructive sale of the underlying stock, provided that the downside exposure or upside potential retained reflects a significant exposure to the underlying stock relative to the term of the option. A put option that is significantly deep in-the-money may be treated as a constructive sale of the underlying position.

Dividends

Eligible dividends received by shareholders before 2011 are generally taxable at the 15% tax rate. Dividends are eligible for the reduced rate only if the underlying stock is unhedged for more than 60 days around the ex-dividend date. A purchased put option is considered a hedge for that purpose, so dividends on the underlying stock will be taxable at regular ordinary income tax rates.

Straddle Rules

Generally, the straddle rules will apply to an equity position if the investor holds an offsetting position that substantially diminishes the risk of loss. This discussion assumes that an investor hedging a stock position that is a capital asset with a put option is subject to the straddle rules.
Under the straddle rules, generally any loss (both on the put option and on any portion of the underlying stock) is deferred to the extent of unrealized gain. However, the investor can make an identified straddle election by identifying which shares are part of the straddle with the purchased put. Loss on an identified straddle is not deferred until all unrealized gain is recognized under the straddle rules but instead is added to the basis of the offsetting straddle position based on the relative amounts of unrealized gains. An identified straddle must be clearly identified on the investor’s records by the close of day on which the put is purchased.

In addition, under the straddle rules, interest and carry costs must be capitalized and an investor’s holding period in the underlying stock is eliminated if the underlying stock has not been held for more than one year when the put option is purchased. For individuals, losses that exceed $2 million and that are from the sale of property that was ever part of a straddle transaction are considered a “reportable transaction” and should be separately disclosed on IRS Form 8886 – Reportable Transaction Disclosure Statement.

Option Lapse

The loss on the lapse of the put generally will equal to the put premium and will be treated as a short-term capital loss unless the investor held the underlying stock for more than one year before the purchase of the put, in which case the loss on the put will be long-term capital loss. This loss is either subject to the general straddle loss deferral rule or added to the basis of the underlying shares if the investor has identified the put option and the underlying shares as an identified straddle. If the investor is selling her entire position, the gain and loss should net, but if this is a hedge of only a portion of her shares, the loss could be deferred until all shares are disposed of, unless the investor has made the identified straddle election, in which case the loss would be added to the basis of the identified hedged shares. Investors are therefore urged to consult their tax advisors regarding the identified straddle election and should consider making the identified straddle election with respect to the put option.

Cash Settlement

The gain or loss on the cash settlement will equal the difference between the premium paid and the amount received to cash-settle the put transaction. If the investor does not simultaneously sell all of the underlying stock upon the termination of the put transaction, all or a portion of any loss from the put transaction will be deferred under the straddle rules until the stock is sold and any gain is realized unless an identified straddle election has been made as discussed above. Any gain from cash settlement of a put transaction will be treated as short-term capital gain and taxed currently. Moreover, in addition to the potential of loss deferral, any loss from cash settlement of a put transaction will be characterized as long-term capital loss, if the underlying stock was held for more than one year prior to the purchase of the put option.

Physical Settlement

If the investor transfers the stock to close out the put, the investor will recognize a short- or long-term capital gain, depending upon the holding period of the stock at the time that the investor purchased the put. The amount of gain will depend on the stock price at expiration. A loss could be recognized upon physical settlement of the put if the tax basis of the stock and the put premium paid exceed the strike price. Special rules apply to physical settlement of straddle positions. Under these rules, if closing out the put for cash would result in a loss, then the investor is treated as terminating the put for its fair market value immediately before settlement and then selling the stock delivered for its fair market value. The loss arising from the deemed cash settlement of the put is either subject to the straddle loss deferral rule or is added to the basis in the underlying shares if the investor has identified the put and the shares as an identified straddle. If the investor is delivering her entire position the gain and loss should net, but if this is a hedge of only a portion of her position, the deemed loss could be deferred until all shares are disposed of unless the investor has made the identified straddle election, in which case the loss would be added to the basis of the identified underlying shares. Investors are therefore urged to consult their tax advisors regarding the identified straddle election and should consider making the identified straddle election with respect to the put option.
The deemed termination of the put only applies if it would otherwise be terminated at a loss. Thus, if there would be a gain upon terminating the put, such as where the stock price is less than the put strike, this deemed sale rule would not apply and the gain or loss would then simply be the difference between the put strike amount received and (1) the cost basis of the shares delivered plus (2) the cost of the put.

**Certain Tax Considerations Related to the Sale of a Call Option**

**Constructive Sale**

A written call option should not result in a constructive sale of the underlying stock provided that the downside exposure or upside potential retained reflects a significant exposure to the underlying stock relative to the term of the option. A call option that is significantly deep in-the-money may be treated as a constructive sale of the underlying position.

**Straddle Rules**

Application of the straddle rules to the sale of covered calls will depend on the details of a particular transaction and thus, must be reviewed with your tax advisor. Generally, the straddle rules will apply to an investor who owns the underlying stock and executes a hedge unless the transaction meets the exception for qualified covered calls discussed below. Under the straddle rules: (1) any gain from cash settlement or lapse of the call option will be treated as short-term capital gain and taxed currently, (2) any loss from cash settlement or lapse of an option will be treated as short- or long-term capital loss, depending upon the holding period of the underlying stock, and (3) all or a portion of any loss from cash settlement or lapse of a option would be deferred to the extent of any unrealized gain in all of the stock unless the investor has made an identified straddle election. If the investor identifies which shares are part of the identified straddle with the sold call, loss on the straddle is not deferred until all unrealized gain is recognized under the straddle rules but instead is added to the basis of the offsetting straddle position based on the relative amounts of unrealized gains. An identified straddle must be clearly identified on the investor’s records by the close of day on which the call is sold.

In addition, under the straddle rules, interest and carry costs must be capitalized and an investor’s holding period in the underlying stock is eliminated if the underlying stock has not been held for more than one year when the call option is sold. For individuals, losses that exceed $2 million and that are from the sale of property that was ever part of a straddle transaction are considered a “reportable transaction” and should be separately disclosed on IRS Form 8886 – Reportable Transaction Disclosure Statement.

Selling covered calls will allow for exemption from the straddle rules if calls are considered Qualified Covered Calls ("QCCs"). QCCs must be written on a single stock and have an expiration greater than 30 days and less than 33 months. The option must not be deep-in-the-money, which means that it must have a strike price greater than or equal to the “lowest qualified benchmark” that will depend on the trading price of the stock and term of the option. Options with a maturity of greater than one year have special rules in determining the “adjusted applicable stock price," with the result being that an “out of the money” option may not meet the QCC exception and selling such an option may result in the call option and the underlying stock being subject to the straddle rules discussed above. In addition, even if the call option is a QCC and the straddle rules do not apply, if the strike price is less than the applicable stock price, the investor’s holding period in the underlying stock will be suspended while the QCC remains outstanding and any loss on the QCC will be long-term capital loss if the underlying stock was held for more than one year prior to the sale of the call. Investors are therefore urged to consult their tax advisors regarding how the qualified covered call rules apply to their respective transaction, particularly for calls with an expiration of more than one year.
Dividends

Eligible dividends received by shareholders before 2011 are generally taxable at the 15% tax rate. Dividends are eligible for the reduced rate only if the underlying stock is unhedged for more than 60 days around the ex-dividend date. Selling covered calls will allow for reduced tax rate on dividends but only if the calls are "QCCs" and are not in-the-money. Investors are urged to consult with their tax advisors in order to determine what is considered to be a strike price that is not in-the-money for these purposes and how the qualified covered call rules apply to their transaction, particularly for calls with an expiration of more than one year.

Option Lapse

Regardless of whether or not the straddle rules apply, any gain the investor will recognize on a lapse of the call will equal the call premium and will be currently taxable as a short-term capital gain.

Cash Settlement

If the call option is cash-settled at expiration, the investor will generally recognize a short-term gain or loss equal to the settlement payment minus the call premium. If the straddle rules do not apply, any gain or loss generally would be treated as short-term gain or loss. However, loss from cash settlement of a QCC with a strike price less than the applicable stock price will be long-term capital loss if the underlying stock was held for more than one year prior to the sale of the QCC. As discussed above, if the straddle rules apply, the loss will either be deferred or capitalized depending on whether the investor elected to treat the call option and the underlying shares as an identified straddle. If the straddle rules apply, loss from cash settlement of call options will be long-term capital loss, if the underlying stock was held for more than one year prior to the sale of the call. Investors are therefore urged to consult their tax advisors regarding the application of the straddle rules to their respective transaction.

Physical Settlement

Any gain recognized by the investor upon the transfer of the stock to close out the call transaction will be treated as short- or long-term capital gain, depending upon the holding period of the underlying stock at the time that the investor sold the call option. The amount of the gain may depend on whether the transaction is subject to the straddle rules or excepted under the rules applicable to QCCs discussed above.

Special rules apply to physical settlement of straddle positions. Under these rules, if closing out the call option for cash would result in a loss, then the investor is treated as terminating the call option for its fair market value immediately before settlement and then selling the stock delivered for its fair market value. The loss arising from the deemed cash settlement of the call is either subject to the straddle loss deferral rule or added to basis in the underlying shares if the investor identified the call and the shares as an identified straddle. If the investor is delivering her entire position the gain and loss should net, but if this is a hedge of only a portion of her position, the deemed loss could be deferred until all shares are disposed of unless the investor has made the identified straddle election, in which case the loss would be added to the basis of the identified underlying shares. Investors are therefore urged to consult their tax advisors regarding the identified straddle election and should consider making the identified straddle election with respect to the call option.

The deemed termination of the call only applies if it would otherwise be terminated at a loss. Thus, if there would be a gain upon terminating the call, such as where the stock price is only slightly above the call strike, this deemed sale rule would not apply and the gain or loss would then simply be difference between the call strike amount received plus the premium and the cost basis of the shares delivered.
Certain Tax Considerations Related to Collar Transactions

Constructive Sale

A collar transaction should not result in a constructive sale of the underlying stock provided that the retained downside exposure or upside potential reflects a significant exposure to the underlying stock relative to the term of the collar.

Stock Loans

Certain hedging transactions of appreciated stock positions have been reviewed by the IRS and the strategy has been recognized as deferring gain recognition. However, in recent situations, the IRS has taken the position in the case of a pre paid forward sale transaction that gain deferral is conditioned on the investor not lending the underlying shares to the counterparty in connection with the transaction.

Loans

In a collar transaction, monetization may be provided under a loan facility, typically structured as a zero-coupon loan. Under proposed regulations, interest expense incurred with respect to a loan that was entered into in connection with stock hedge by a collar is subject to a special limitation. Generally, the amount of interest expense that is deductible is limited to the income, such as dividends, received from the underlying stock position. Any excess interest expense is required to be capitalized and is added to the investor’s tax basis in the underlying stock.

Dividends

Eligible dividends received by shareholders before 2011 are generally taxable at the 15% tax rate. Dividends are eligible for the reduced rate only if the underlying stock is unhedged for more than 60 days around the ex-dividend date. A purchased put option is considered a hedge for that purpose, so dividends on the underlying stock will be taxable at regular ordinary income tax rates.

Straddle Rules

Generally, the straddle rules will apply to an equity position if the investor holds an offsetting position that substantially diminishes the risk of loss. This discussion assumes that an investor is hedging a stock position that is a capital asset with a collar transaction that is treated as a single financial contract and is subject to the straddle rules. Under the straddle rules, generally any loss (both on the collar and on any portion of the underlying stock) is deferred to the extent of unrealized gain. However, the investor can make an identified straddle election by identifying which shares are part of the straddle with the collar. Loss on an identified straddle is not deferred until all unrealized gain is recognized under the straddle rules but instead is added to the basis of the offsetting straddle position based on the relative amounts of unrealized gains. An identified straddle must be clearly identified on the investor’s records by the close of day on which the collar is entered into.

In addition, interest and carry costs must be capitalized and an investor’s holding period in the underlying stock is eliminated if the underlying stock has not been held for more than one year when the collar transaction is entered into. For individuals, losses that exceed $2 million and that are from the sale of property that was ever part of a straddle transaction are considered a “reportable transaction” and should be separately disclosed on IRS Form 8886 – Reportable Transaction Disclosure Statement.
Cash Settlement or Lapse
The investor will recognize a gain or loss, equal to the difference between the amount paid or received upon entering into the collar transaction and the amount paid or received to cash settle the collar transaction. If the investor does not simultaneously sell the stock upon the termination of the collar transaction, all or a portion of any loss from the collar transaction may be deferred under the straddle rules until all of the stock is sold and any gain is realized unless an identified straddle election has been made as discussed above. Any gain from cash settlement or lapse of a collar transaction will be treated as short-term capital gain. Moreover, in addition to the potential of loss deferral, any loss from cash settlement or lapse of a collar transaction will be characterized as long-term capital loss, if the underlying stock was held for more than one year prior to the execution of the collar transaction.

Physical Settlement
Any gain recognized by the investor upon the transfer of the stock to close out the collar transaction will be treated as short-term or long-term capital gain, depending upon the holding period of the stock at the time that the investor entered into the collar transaction. Special rules apply to physical settlement of straddle positions. Under these rules, if closing out the collar transaction for cash would result in a loss, then the investor is treated as terminating the collar transaction for its fair market value immediately before settlement and then selling the stock delivered for its fair market value. The loss arising from the deemed cash settlement of the collar transaction is either subject to the straddle loss deferral rule or added to basis in the underlying shares if the investor identified the collar transaction and the shares as an identified straddle. If the investor is delivering her entire position the gain and loss should net, but if this is a hedge of only a portion of her position, the deemed loss could be deferred until all shares are disposed of unless the investor has made the identified straddle election, in which case the loss would be added to the basis of the underlying shares. Investors are therefore urged to consult their tax advisors regarding the identified straddle election and should consider making the identified straddle election with respect to the collar.

The deemed termination of the collar transaction only applies if it would otherwise be terminated at a loss. Thus, if there would be a gain upon terminating the collar transaction, such as where the stock price is less than the put strike, this deemed sale rule would not apply and the gain or loss would then simply be the difference between the put strike amount received and the cost basis of the shares delivered.

Certain Tax Considerations Related to Prepaid Forward Sale Transactions

Constructive Sale
A prepaid forward sale transaction should not result in a constructive sale of the underlying stock provided that the retained downside exposure or upside potential that is a function of the variable share delivery formula reflects a significant exposure to the underlying stock relative to the term of the transaction.

Stock Loans
Prepaid forward sales have been reviewed by the IRS and the strategy has been recognized as deferring gain recognition. However, in recent situations, the IRS has taken the position that gain deferral is conditioned on the investor not lending the underlying shares to the counterparty in connection with the transaction.
Prepayment

The prepayment (“initial proceeds”) in a prepaid forward sale transaction reflects the discounted present value of the future minimum sale price. The discount rate is comparable to the current finance rate; however, because the prepayment is not a loan, no interest expense is recognized for tax purposes. The tax benefit of the implied financing is reflected as reduced sale proceeds recognized upon closing the forward sales transaction. The net effect is similar to the capitalization of interest except there is no ability to offset current dividend income with the implied financing cost.

Dividends

Eligible dividends received by shareholders before 2011 are generally taxable at the 15% tax rate. Dividends are eligible for the reduced rate only if the underlying stock is unhedged for more than 60 days around the ex-dividend date. A prepaid forward sale transaction is considered a hedge for that purpose, so dividends on the underlying stock will be taxable at regular ordinary income tax rates.

Straddle Rules

Generally, the straddle rules will apply to an equity position if the investor holds an offsetting position that substantially diminishes the risk of loss. This discussion assumes that an investor is hedging a stock position that is a capital asset with a pre-paid forward sale and the transaction is subject to the straddle rules.

Under the straddle rules, generally any loss is deferred to the extent of unrealized gain. However, the investor can make an identified straddle election by identifying which shares are part of the straddle with the prepaid forward sale transaction. Loss on an identified straddle is not deferred until all unrealized gain is recognized under the straddle rules but instead is added to the basis of the offsetting straddle position based on the relative amounts of unrealized gains. An identified straddle must be clearly identified on the investor’s records by the close of day on which the prepaid forward sale is entered into.

In addition, under the straddle rules, interest and carry costs must be capitalized and an investor’s existing stock holding period is eliminated if the underlying stock has not been held for more than one year when the prepaid forward sale transaction is executed. For individuals, losses that exceed $2 million and that are from the sale of property that was ever part of a straddle transaction are considered a “reportable transaction” and should be separately disclosed on IRS Form 8886 – Reportable Transaction Disclosure Statement.

Cash Settlement or Lapse

The investor will recognize a gain or loss, equal to the difference between the amount received upon entering into the prepaid forward sale transaction and the amount paid to cash-settle the prepaid forward sale transaction. If the investor does not simultaneously sell the stock upon the termination of the prepaid forward sale transaction, all or a portion of any loss from the pre-paid forward sale transaction will be deferred or added to basis under the straddle rules and not recognized until there is no longer any unrealized gain in the stock or the stock is sold, unless the investor has made an identified straddle election as discussed above, in which case, the loss will be added to the basis of the underlying shares. Any gain from cash settlement or lapse of a prepaid forward sale transaction will be treated as short-term capital gain and taxed currently. Moreover, in addition to the potential of loss deferral, any loss from cash settlement or lapse of a prepaid forward sale transaction will be characterized as long-term capital loss, if the underlying stock was held for more than one year prior to the execution of the prepaid forward sale transaction.
Physical settlement

Any gain recognized by the investor upon the transfer of the stock to close out the prepaid forward sale transaction will be treated as short- or long-term capital gain, depending upon the holding period of the stock at the time that the investor entered into the prepaid forward sale transaction. Special rules apply to physical settlement of straddle positions. Under these rules, if closing out the prepaid forward sale transaction for cash would result in a loss, then the investor is treated as terminating the prepaid forward sale transaction for its fair market value immediately before settlement and then selling the stock delivered for its fair market value. The loss arising from the deemed cash settlement of the prepaid forward sale transaction is either subject to the straddle loss deferral rule or added to basis if the investor identified the prepaid forward sale transaction as an identified straddle. If the investor is delivering her entire position the gain and loss should net, but if this is a hedge of only a portion of her position, the deemed loss could be deferred until all shares are disposed of unless the investor has made the identified straddle election, in which case the loss would be added to the basis of the underlying shares. Investors are therefore urged to consult their tax advisors regarding the identified straddle election and should consider making the identified straddle election with respect to the prepaid forward sale transaction.

The deemed termination of the prepaid forward transaction only applies if it would otherwise be terminated at a loss. Thus, if there would be a gain upon terminating the prepaid forward sale transaction, such as where the stock price is less than the amount received at inception, this deemed sale rule would not apply and the gain or loss would then simply be the difference between the amount received at inception and the cost basis of the shares delivered.

APPENDIX B: RULES 144 AND 145 UNDER THE SECURITIES ACT OF 1933

The investment transactions or strategies described in this publication are governed by, and subject to, certain laws, rules and regulations. Nothing contained herein should be interpreted as a comprehensive statement of such laws, rules and regulations. Rather, any such information is intended to give investors a broad overview of such laws, rules and regulations. Investors should reference the actual law, rule and regulation for a complete understanding of the law, rule and regulation. Such laws, rules and regulations are subject to change at any time and any changes may not be reflected herein. As always, investors should consult their professional advisors prior to entering into any investment transaction or strategy.

Securities Act of 1933

Unless a specific exemption is available, the Securities Act of 1933 (the “Securities Act”) generally requires registration of every offer and sale of securities made in the United States or to US persons. Exemptions to that rule cover certain types of securities being offered (certain governmental, bank and other securities), as well as types of transactions, pursuant to which the securities are sold. Most common “transactional” exemptions include private transactions (initial private placements and certain private resales), standard secondary market transactions (ordinary transactions by dealers and brokers) and certain foreign jurisdiction transactions (for example, transactions subject to Regulation S under the Securities Act).

In addition, Rule 144 under the Securities Act provides a significant avenue for parties seeking to resell nonregistered securities (so-called “restricted securities”) and for affiliates of issuers (often referred to as “control persons”) seeking to resell their securities (so-called “control securities”). It is important to note that the “restricted” status of securities relates to the manner of their issuance, whereas the “control” status results from the identity of the party owning the securities, thus the securities can have both “restricted” and “control” characters.
Rule 144 – Restricted Securities

Restricted securities are securities acquired directly or indirectly from the issuer in a transaction or series of transactions not involving a “public offering” (for example, private placements by issuers and private acquisitions from affiliates of issuers, gifts, compensation arrangements and various distributions). Due to the certificated format in which the companies often issue these securities, they are often called “legended” securities.

According to revised rules, effective as of February 15, 2008, restricted securities of companies current in their reporting under the Securities Exchange Act of 1934 (the “Exchange Act”) must be held for at least six months (or one year for securities of certain “nonreporting” issuer companies) by persons other than “affiliates” of the issuer before a public sale is permissible. Once the six-month period expires, any sales of such securities are not subject to any limitations, so long as the issuer remains a “reporting” company and current in its Exchange Act filings at the time of the sale if the sale is during the six months following such initial six-month period.

Rule 144 – Control Securities

Rule 144 provides for an exemption for sales of securities held by certain affiliates of the issuer. Control securities, whether purchased in the open market or acquired directly from the issuer, absent another exemption, can only be sold publicly subject to restrictions contained in Rule 144. As indicated in the preceding paragraph, if the control securities are also restricted, they must be held for at least six months (or one year for securities of certain “nonreporting” issuer companies) before a sale subject to restrictions of Rule 144 is permissible.

Rule 144 restrictions applicable to sale of control securities generally relate to (i) the amount of such securities that may be sold within a given period, (ii) the manner in which such sales can be made, (iii) current reporting requirements applicable to the underlying issuer and (iv) the notice requirements applicable to such sales.

Rule 145 – Business Combination Securities

As a result of the amendments to the rules as mentioned above, effective as of February 15, 2008, Rule 145 has been rendered only marginally relevant to resales of “restricted” or “control” securities. Following the amendments, affiliates of target companies (who are not also affiliates of the issuer-acquirer), who received securities of the issuer in connection with registered mergers, acquisitions and similar transactions (“Rule 145 transactions”), generally can freely sell the securities received in such transactions. Obviously, provisions of Rule 144 continue to apply to holders of “restricted” and “control” securities of the issuer-acquirer and to any securities acquired by the holders of the target, if such securities were acquired not in a Rule 145 transaction, but in an ordinary private transaction.

Rule 145 is only applicable to transactions involving certain “shell companies.” That means that public sales of securities acquired by the security holders of a “shell company” in Rule 145 transactions by affiliates of the target company remain subject to the registration requirements of the Securities Act or, absent another exemption, can only be sold subject to certain Rule 145 restrictions similar to those of Rule 144.
**Figure 5. Summary Table of Rule 144 for Exchange Act Reporting Company Issuers**

<table>
<thead>
<tr>
<th></th>
<th>Restricted (Legended) Securities; Seller is a Nonaffiliate</th>
<th>Physical Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holding period (calculated from the date of full payment)</td>
<td>Six months</td>
<td>Six months for restricted securities; no holding period for other securities</td>
</tr>
<tr>
<td>Current public information</td>
<td>Company must have filed current financial information with the Securities and Exchange Commission (“SEC”) during the preceding 12 months (if the sale occurs prior to the holding period reaching 12 months) and be a “reporting company” under the Exchange Act for 90 days.</td>
<td>At the time of the sale, company must have filed current financial information with the SEC during the preceding 12 months and be a “reporting company” under the Exchange Act for 90 days.</td>
</tr>
<tr>
<td>Limitations on amount of securities to be sold</td>
<td>Not applicable</td>
<td>Applicable; generally, the greater of: (i) 1% of the outstanding shares of the class of the securities being sold and (ii) the average weekly trading volume during the four calendar weeks preceding the week during which the sale is being made.</td>
</tr>
<tr>
<td>Restrictions on manner of sale</td>
<td>Not applicable</td>
<td>Applicable; generally, the methods of sale are limited to (i) certain “unsolicited” broker’s transactions, (ii) transactions directly with a “market maker” and (iii) certain “riskless principal” transactions.</td>
</tr>
<tr>
<td>Filing of Form 144 with SEC</td>
<td>Not applicable</td>
<td>Applicable; the form filing is required if the amount of securities being sold is greater than (i) 5,000 securities or (ii) $50,000 worth of such securities.</td>
</tr>
</tbody>
</table>

**APPENDIX C: DISCLOSURE REQUIREMENTS UNDER SECTION 13 OF THE EXCHANGE ACT**

The investment transactions or strategies described in this publication are governed by, and subject to, certain laws, rules and regulations. Nothing contained herein should be interpreted as a comprehensive statement of such laws, rules and regulations. Rather, any such information is intended to give investors a broad overview of such laws, rules and regulations. Investors should reference the actual law, rule and regulation for a complete understanding of the law, rule and regulation. Such laws, rules and regulations are subject to change at any time and any changes may not be reflected herein. As always, investors should consult their professional advisors prior to entering into any investment transaction or strategy.

**Sections 13(d) and 13(g)**

Sections 13(d) and 13(g) of the Exchange Act, and rules relating to those sections, generally require that persons or entities that become “beneficial owners” (including holders of certain option and derivative positions) of 5% or more of a class of any equity security of a publicly reporting company (i) disclose such ownership stake to the SEC and to the issuer, (ii) specify, by selecting a specific filing form, whether such stake is held solely with a “passive investment purpose” or with a “purpose or the effect of changing or influencing the control of the issuer” and (iii) continue to report any changes to their ownership or their intent with respect to the issuer.
APPENDIX D: SECTION 16 OF THE EXCHANGE ACT

The investment transactions or strategies described in this publication are governed by, and subject to, certain laws, rules and regulations. Nothing contained herein should be interpreted as a comprehensive statement of such laws, rules and regulation. Rather, any such information is intended to give investors a broad overview of such laws, rules and regulations. Investors should reference the actual law, rule and regulation for a complete understanding of the law, rule and regulations. Such laws, rules and regulations are subject to change at any time and any changes may not be reflected herein. As always, investors should consult their professional advisors prior to entering into any investment transaction or strategy.

Section 16(a) — Reporting Requirements

Section 16(a) of the Exchange Act requires officers, directors and “beneficial owners” of more than 10% (“insiders”) of a class of any equity security of a publicly reporting issuer (other than “foreign private issuers”) to file certain form reports with the SEC disclosing their equity interest in the issuer (including options and other derivative securities) and any changes in such ownership interest.

Section 16(b) — Short-Swing Profits

Under Section 16(b) of the Exchange Act, if within any six-month period an insider buys and sells, or sells and buys, any equity security of the issuer (or enters into or settles any options and other derivative securities on such equity securities) and realizes any net positive difference between the prices of any such transactions, or earns a premium from the sale of any option that expires or is cancelled within a six-month period, the insider may be subject to “disgorgement” to the issuer of such net positive difference or premium.

Section 16(c) — Short Positions

Section 16(c) generally prohibits insiders from holding “naked” short positions on any equity interest in the issuer (including equivalent option and other derivative positions).

APPENDIX E: INVESTOR ELIGIBILITY REQUIREMENTS FOR OVER-THE-COUNTER OPTIONS TRANSACTIONS

Accredited Investor

An individual must be an accredited investor under the Securities Act to enter into over-the-counter options. An accredited investor (either alone or jointly with his or her spouse) must have a net worth in excess of US$1 million or income over $200,000 ($300,000 if joint) per year for the past two years and has a reasonable expectation of reaching the same income level in the current year. Over-the-counter option transactions are carried out as private placements and are not registered under the Securities Act.

Approved for Listed Options

Certain investors must be approved to trade listed options.

Eligible Contract Participant

To enter in a swap or cash settled prepaid forward sale transaction, an individual must be an eligible contract participant under the Commodity Exchange Act (total assets in excess of $5 million if transaction is for hedging purposes).
APPENDIX F: GLOSSARY OF TERMS

Put option: A physically settled put option gives the holder the right to sell the underlying asset at a given price (the “strike price”) on or before a specific date (the “expiration date”).

Call option: A call option gives the holder the right to buy the underlying asset at a given price (the “strike price”) on or before a specific date (the “expiration date”).

Strike price: The price at which the underlying security may be bought (call) or sold (put).

Underlying security: The equity, fixed-income, interest rate or commodity asset underlying the option contract.

Expiration date: The last date on which the option may be exercised.

European-style option: Exercisable only on the expiration date.

American-style option: Exercisable on or before the expiration date.

Cash settlement: The settlement of an option contract or other equity derivative contract through the payment of cash in the amount by which the contract is in-the-money as opposed to delivering or receiving the underlying security.

Physical settlement: The settlement of an option contract or other equity derivative contract through the delivery or receipt of the underlying security for payment of the strike price.

Over-the-counter option: A customized option that is privately negotiated between a financial institution and a counterparty. Strike prices, expirations, underlying securities and settlement features are negotiable.

Listed option: An option that is registered on an exchange, such as the CBOE, American and Philadelphia Stock Exchanges. Strike prices, expirations, underlying securities and settlement features are generally fixed.

In-the-money: A call option is considered “in-the-money” when the call option’s strike price is lower than the prevailing market price of the underlying stock, thus allowing its holder to buy the underlying stock at lower than the prevailing market price by exercising the call option. A put option is considered “in-the-money” when the put option’s strike price is higher than the prevailing market price of the underlying stock, thus allowing its holder to sell the underlying stock at higher than the prevailing market price by exercising the put option.
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