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Unit Investment Trusts and Structured UITs

Thursday, May 4, 2017

8:30 AM – 9:30 AM EDT

Alaia Capital and Morrison & Foerster Seminar

Presenters:

Oscar Loynaz and Paul Koo, Alaia Capital, LLC
Anna Pinedo, and Bradley Berman, Morrison & Foerster LLP

1. **Presentation**
2. **"Sales of Unit Investment Trusts and Discharging Fiduciary Duties"**
3. **"Summary – Advantages/Disadvantages:**
   Unit Investment Trust; Closed End Fund; Repackaging (Grantor Trust); Custodial Arrangement/Receipt"
4. **"Summary of DOL Conflict Rule, BICE and Principal Transaction Exemption"**
5. **Client Alert: "DOL Fiduciary Rule Delayed by 60 Days"**
6. **Client Alert: "DOL Issues Additional Guidance on Fiduciary Rule"**
7. **Client Alert: "DOL Issues First Guidance on Fiduciary Rule"**
8. **"Structured Thoughts: News for the financial services community, Volume 8, Issue 4"**

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Unit Investment Trusts and Structured UITs

Oscar Loynaz and Paul Koo, Alaia Capital, LLC

Anna Pinedo and Bradley Berman, Morrison & Foerster

May 4, 2017

Overview

What is a Unit Investment Trust?

A UIT is a type of registered investment company under the Investment Company Act of 1940 (the "1940 Act").

- An investment company is an issuer that holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities.
- Because UITs issue securities, and use the issuance proceeds to invest in securities, they fall within the definition of an "investment company" under Section 3 of the 1940 Act.

How is a UIT Different from other Investment Companies?

The most significant distinguishing characteristic of a UIT compared to other investment companies is that it has virtually no management.

- UITs employ a "buy and hold" strategy, and once the portfolio securities are selected, they generally do not change.
- Section 4(2) of the 1940 Act defines a UIT as an investment company "which (A) is organized under a trust indenture, contract, custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. . . ."
- UITs are passive and are not managed; UITs do not have an investment adviser that determines an investment strategy or manages portfolio holdings.
  - Fixed portfolio securities are deposited with the trustee and remain in the trust with little change for the duration of the UIT's existence
- UITs also do not have a board of directors to oversee the operation of the trust, nor do they have officers, and have a fixed termination date.

UIT Characteristics

- A UIT makes a one-time public offering of only a specific, fixed number of redeemable securities called "units."
  - Investors receive a share of the principal and dividends (or interest).
  - Payments can occur monthly, quarterly, semi-annually or at termination.
  - Usually permissible to reinvest dividends or interest.
- A UIT must have a stated date for termination.
  - Investors receive a proportionate share of the UIT's net assets.
  - Term may vary from less than one year to 30 years depending on the underlying portfolio.
- Liquidity
  - A UIT may be listed on a national securities exchange.
  - Investors can redeem outstanding units at their net asset value.
  - Some UITs permit investors to exchange their units for units of another UIT.

Types of Assets

Historically, there have been three asset classes for UITs:

- Tax exempt UITs invest in a portfolio of municipal bonds;
- Taxable debt UITs invest in a portfolio of U.S. and/or non-U.S. corporate bonds and/or government agency certificates; and
- Equity UITs invest in stocks in a particular sector, that reflect a strategy or are consistent with a defined investment objective (e.g., "Dogs of the Dow").

UITs with a structured product-type payoff may invest in other assets:

- Exchange-traded options, U.S. Treasury obligations and/or cash or cash equivalents
  - For the Alaia UIT, the unit's value was based on the leveraged performance of the SPDR® S&P 500® exchange traded fund up to a cap, with a downside buffer.

How are UITs organized?

- Nearly all UITs elect to organize as a trust under state law.
- A UIT may be organized as a single trust, or a series trust, with each series constituting a different portfolio.
- By creating several series, a UIT can sell units of numerous portfolios without having to register an entirely new trust under the 1940 Act.
- The trust indenture, or similar governing agreement, governs both the trust and the activities of those associated with the UIT, such as the trustee, sponsor/depositor and evaluator.

Who are the parties, and what are their roles?

Sponsor/depositor:

- Organize the UIT, and bear the initial organizational costs
  - Sponsors may be reimbursed by the UIT for these costs
- Are registered broker-dealers
  - Sponsors are usually the UIT's principal underwriter
- Create a marketable portfolio of securities
- Establish the UIT's investment objective
- Deposit the securities (or contracts to purchase the securities) with a trustee pursuant to the terms of the trust indenture or agreement
  - In exchange for the deposit of securities (or contracts), the sponsor receives unit certificates representing shares of ownership
- Are compensated for their services by the sales charge (load), and may also be compensated for providing portfolio supervisory services, subject to limitations
- May be prohibited from acting as a sponsor if prohibited due to certain past bad acts under Section 9 of the 1940 Act

Evaluators:

- Are responsible for valuing the securities held by the UIT and may also perform other supervisory services as well
  - This valuation is used to establish the unit offering price
- Typically receive a fixed annual fee for their services
- May be independent from the sponsor/depositor, but do not have to be, and may often be an affiliate

The trustee's role is analogous to that of a custodian. The trustee:

- Maintains the UIT's assets, records ownership and ensures that any advances received are credited and that the UIT's expenses are paid
- May also be responsible for reporting to the unitholders
- Receives a fee, which is typically based upon the total value of the UIT
- Is subject, under Section 26 of the 1940 Act, to certain minimum requirements to ensure, for example, its solvency and its ongoing ability to meet its responsibilities

Who are the parties, and what are their roles?, cont'd.

Affiliate Transactions

Section 17(a)(1) of the 1940 Act prohibits an affiliated person of an investment company from knowingly selling any security or other property to the investment company.

- Under certain circumstances, a UIT may, as an investment strategy, choose to invest in certain other series of the same UIT or a different UIT within the same investment complex.
- If such series are under the control of the same depositor, they could be affiliates, and the sale or redemption of their units could be deemed to be a principal transaction prohibited under Section 17(a).
  - In this event, a UIT would seek and receive exemptive relief from the SEC under Sections 6(c) and 17(b) of the 1940 Act.
- Affiliate transactions between a UIT and its depositor are excepted from the prohibition by Section 17(a)(1)(C) of the 1940 Act.

Sales Charges

A typical unit is subject to a front-end sales charge, a deferred charge or a combination of both.

- When sold with a front-end sales charge, the price per unit is equal to its net asset value ("NAV") plus the sales charge assessed.
- When sold with a deferred sales charge, collection of the charge is deferred over a period of time after the initial purchase of the unit. Generally, the deferred charge is deducted from the holder's distributions until the entire amount is paid.
- If a unit is redeemed before the entire charge has been paid, the balance of the charge is deducted from the redemption proceeds.

Redemptions

By definition, a UIT must issue redeemable securities.

- A "redeemable security," as defined in Section 2(a)(32) of the 1940 Act, includes a security that by its terms entitles the holder to present it to the issuer (or someone designated by the issuer) and to receive approximately the value of the holder's proportionate share of the issuer's current net assets. Unless a secondary market is maintained, a UIT and its sponsor, therefore, must be ready to redeem units.
- If units are redeemed for their cash value, the 1940 Act requires that they be redeemed at NAV, which is calculated daily. For these purposes, the redemption price is the NAV per unit calculated on the date the trustee receives the redemption notice.
- Charging a deferred sales charge raises issues with respect to the units' redemption, because the investor will receive less than the units' full value upon redemption.
  - In practice, however, UITs issuing units subject to a charge of this type seek and receive exemptive relief from the SEC that permits deferred sales charges.

SEC Registration

Registration and disclosure under the securities laws

UITs are subject to dual registration requirements.

- The units must be registered and a registration statement deemed effective by the SEC under Section 5 of the Securities Act of 1933 (the "Securities Act")
  - Units are registered under the Securities Act on a Form S-6
  - Each subsequent series of a UIT must also register separately on a Form S-6
- The UIT, as an investment company, must be registered with the SEC on Form N-8B-2.

What is Form N-8B-2?

Generally, Form N-8B-2 includes information such as:

- A summary of the material terms of the trust indenture and other contracts into which the trust has entered;
- A description of the securities offered;
- A description of sales loads, fees, charges and expenses;
- Information regarding the sponsor;
- Distribution arrangements;
- Information regarding the trustee, custodian and other service providers;
- Information regarding portfolio insurance, if applicable;
- Tax information; and
- Audited financial statements.

The Form N-8B-2 is subject to review by the SEC's Division of Investment Management.

What is Form S-6?

To register units for a public offering, each series of the UIT must file a separate Form S-6. Each series must also prepare its own preliminary prospectus, which is used by the underwriter or underwriting syndicate to obtain indications of interest in the units.

- Form S-6 generally requires disclosure, in a prospectus, of information similar to that required in Form N-8B-2.
- The filing for the initial series of a UIT on Form S-6 is subject to review by the SEC's Division of Corporation Finance.

How are subsequent series registered?

- While there is no “shelf registration” process for UITs, UITs organized as a series trust are afforded some flexibility for conducting subsequent series offerings by Rule 487 under the Securities Act.
- To avail itself of this flexibility, the initial series of a UIT must file a Form S-6 registration statement that is subject to review by the SEC. Once the SEC has declared the Form S-6 for the initial series effective, the UIT may rely on Rule 487 for offerings of units of future series.

What are the conditions to use Rule 487?

- Rule 487 permits the Form S-6 registration statement relating to a subsequent series of a UIT to become effective automatically without affirmative action by the SEC if it satisfies a number of conditions:
  - The UIT must identify one or more prior series that the SEC has declared effective;
  - The UIT must represent that the securities deposited in the new series being registered do not differ materially in type or in quality from those deposited in the prior series, and the disclosure in the prospectus for the series being registered may not differ materially from the disclosure in the prior series' registration statement; and
  - The UIT must deliver a preliminary prospectus in compliance with Rule 460 (delivery to underwriters).
- This process has the effect of permitting frequent offers by series of the UIT on an expedited basis.

Rule 487 practice points

- The SEC is strict regarding the availability of Rule 487 for subsequent series. For example:
  - Rule 487 was not available for a UIT with a buffered, leveraged and capped payoff structure linked to the performance of IWM, when the precedent series was linked to the performance of SPY
  - The SEC's rationale was that because the underlying index was different (RTY v. SPX), and there would be an additional risk factor for small-capitalization companies, there was a material difference
  - It is good practice to check with your examiner prior to relying on Rule 487.
  - A Rule 487 S-6 is generally just three pages long – a facing page, identification of a prospectus for a previously effective series that will be used as the preliminary prospectus for the current series, and the signature page and exhibit list.

Ongoing reporting requirements

Section 10(a)(3) of the Securities Act requires that a UIT's prospectus be maintained and updated. In order to accomplish this, sponsors typically file post-effective amendments to the UIT's registration statement.

In addition to maintaining a current registration statement, like many other issuers and investment companies, a UIT is subject to ongoing reporting obligations under the Exchange Act. A UIT may satisfy its periodic reporting obligations under the Exchange Act by filing a Form N-SAR under Rule 30a-1 of the 1940 Act within 60 days after the close of each calendar year. The sponsor, in conjunction with the trustee, typically prepares this annual report on behalf of the UIT.

The Form N-SAR is required to disclose information regarding, among other things:

- Information about the sponsor and trustee;
- Sales during the period;
- Affiliated transactions; and
- Sales loads and other fees and expenses.

The Form N-SAR is not required to contain audited financial statements and UITs are not required to provide unitholders with annual reports containing financial statements. As a result, UITs are exempt from the certification requirements of Section 302 of Sarbanes-Oxley. In practice, however, the trustee typically will provide an annual report to unitholders detailing the activities of the trust. This report customarily contains audited financial statements and the trustee's discussion of fund operations and investment results.

Other Considerations

Advertising

UIT advertising materials are subject to several SEC rules and also FINRA requirements.

- Rule 482 under the Securities Act covers Investment Company advertisements for securities subject to a filed registration statement;
  - This rule allows the UIT issuer to include in the advertisement information not included in the prospectus
  - Rule 482 will require certain disclosures and legends, depending on the content of the advertisement
- Rule 156 under the Securities Act provides guidance about factors to be weighed in determining whether an Investment Company's sales literature is misleading
- Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder prohibit misstatements and omissions in connection with the purchase or sale of any security
- The review, recordkeeping, filing and content requirements of FINRA Rule 2210 (Communications with the Public) apply to UIT advertisements used by a FINRA member, including Rule 482-compliant advertisements

FINRA's view, expressed in a recent conference:

- Concern that, without adequate disclosures, investors may confuse structured products in the form of 1940 Act "wrappers" with more traditional mutual funds and may not be aware of their unique terms and risks;
- FINRA considers structured 1940 Act vehicles to raise the same concerns as discussed in the 2009 release on leveraged and inverse ETFs; and
- Market participants should exercise care in preparing advertising materials and in training sales personnel.

Advertising, cont'd.

Blue Sky requirements

Section 18(b) of the Securities Act preempts state law with respect to, and prohibits states from imposing registration requirements or standards upon, companies that are registered under the 1940 Act, among others. While a UIT is, therefore, not subject to substantive review by state securities officials, it still must comply with each state's blue sky requirements prior to offering the sale of units in that state. Requirements vary from state to state, but many states require an initial notice filing, such as a filing on Form NF, or a state's version of the notice filing, and renewal notices. Other states require the filing of the UIT's SEC-filed registration statement. States may also require that a UIT file a Form U-2, or similar form, consenting to the service of process in that state. Moreover, UITs are subject to state registration and renewal fees, which vary from a flat registration fee to a percentage of the total aggregate offering price.

Compliance

- The Investment Company Act framework applies to UITs. For example:
  - Rule 17j-1 of the Investment Company Act requires that UITs adopt a written code of ethics to mitigate conflicts of interest between the registered investment company personnel and their funds
  - Rule 38a-1 under the Investment Company Act requires that a UIT
    - Adopt policies and procedures to prevent securities law violations,
    - Review those policies at least annually for adequacy
    - Appoint a chief compliance officer
- Investment companies must comply with Rule 35d-1 regarding naming conventions. A UIT that uses a name that suggests a focus has to devote at least 80% of its assets in that area of focus
- UIT sponsors often may seek exemptive relief related to:
  - Deferred sales charges
  - "Layering," which refers to prohibitions on fund investments in other funds

Tax

- Tax treatment
  - Pass-through tax treatment (i.e., no tax at the entity level) as either:
    - A grantor trust for U.S. federal income tax purposes
      - Each unitholder would be subject to taxation as if it owned directly a pro rata share of the trust assets.
    - A "regulated investment company"
      - The UIT must distribute substantially all of its income and capital gain on an annual basis.
      - Tax treatment like most ETFs

UITs and the DOL Fiduciary Rule

Background

- DOL Fiduciary Rule significantly expands the category of persons who are deemed "fiduciaries"
  - Any person who, for compensation, makes any form of recommendation as to an investment, investment strategy or investment adviser may be a fiduciary
- Fiduciaries may not be paid a commission when selling to retail retirement accounts, unless the sale fits within an applicable exemption
- Best Interest Contract Exemption ("BIC Exemption") is available for most investment products, but only applies to sales made on an agency basis
- Principal Transactions Exemption applies to sales made on a principal basis, but only covers a limited range of investment products

Principal Transactions Exemption

- The Principal Transactions Exemption is available for sale of:
  - Unit Investment Trusts ("UIT")
  - Certificates of Deposit ("CD")
  - Debt Securities
    - Corporate debt
      - Issuer must be a U.S. corporation
      - Dollar-denominated debt
      - Sold through an SEC-registered offering
    - U.S. Treasuries
    - U.S. Agencies
    - Asset-backed securities guaranteed by a U.S. Agency or GSE

Principal Transactions Exemption - 2

- Fiduciaries proposing to sell under the Principal Transactions Exemption must comply with impartial conduct standards
  - Act in client's best interest
  - Best execution
  - Full and fair disclosure
- Fiduciaries must also comply with certain contract and disclosure requirements specified in the Principal Transactions Exemption
- Additional requirements are imposed on the sale of Debt Securities, but not UITs
  - Debt Securities were not issued by the Financial Institution or any affiliate
  - Financial institution is not acting as an underwriter
  - Debt Securities have no more than a moderate degree of credit risk
  - Debt Securities are sufficiently liquid to be sold at or near carrying value in reasonably short period of time

UITs vs. Debt Securities

Feature	UITs	Debt Securities
May sell through an underwritten offering	Yes	No
Must possess no more than moderate credit risk	No	Yes
Must be sufficiently liquid to sell at or near carrying value within a reasonably short period of time	No	Yes

Advantages of UITs

- All UITs may be sold under the Principal Transactions Exemption
  - No need to restructure distribution arrangements to sell on agency or riskless principal basis
  - No restrictions on selling product issued by an affiliate
- Financial institutions may sell UITs under the Principal Transactions Exemption without concern about meeting the uncertain credit and liquidity standards applicable to Debt Securities
  - Lack of definitions or guidance from DOL
- Liquidity built into UITs facilitates a conclusion that the product is in the best interest of the customer

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The Alaia Market Linked Trust

May 2017

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Alaia Capital Background

- Alaia Capital is an independent financial services firm focused on innovative and alternative investment solutions.

- Along with its affiliates, Alaia Capital was created to address the current limitations within traditional and existing investment products.
  - *Leverages strong leadership, experience & industry contacts of founders, each with 20+ year careers at top tier global investment banks*

- By partnering with top-tier institutions, Alaia's business is focused on delivering outcome-driven and/or structured investment solutions within a fiduciary framework
  - *Addresses a large and growing pent-up demand for outcome and structured solutions in fund format*

- Solutions built for both for selective private access and broad-based US public access
  - *US 40 Act registered outcome driven UITs: The Alaia Market Linked Trust*
  - *Private funds*

What is the Alaia Market Linked Trust?

- Alaia Market Linked Trust is a Unit Investment Trust (UIT) platform that has been created to focus on UITs with outcome driven investment objectives and payoffs linked to particular ETFs
  - *Same product attributes of SNs. However the platform* ***solves several of the frictions existent in SNs***

- First ever US registered '**40 Act** fiduciary platform that delivers **turnkey scalable structured funds**, with quick turnaround, efficient cost structure, large capacity and targets a defined structured payoff

Structure Flexibility	Various series filed allow for delivering a wide range of potential payoffs and underlyings

- UITs have a fixed portfolio that replicates an outcome-driven investment strategy at maturity:
  - *Exchange listed FLexible EXchange® (FLEX) options on an ETF, plus*
  - *US Treasury securities and cash/cash equivalents*

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What is the Alaia Market Linked Trust?

- Derivatives that are part of the fixed portfolio:
  - *FLEX listed options are listed on a national exchange (like the CBOE) and guaranteed and issued by the Options Clearing Corporation ("OCC") (AA+ rating ~ in line with the US Government rating)*

Marginal/Limited Credit Exposure	Given the asset composition, risk of repayment of all obligations is in line with that of US Government obligations

- All assets of the fixed portfolio are subject to institutional-level price discovery:

Competitive Pricing	All assets, and consequent terms, reflect a best-ex institutional level auction. There are no credit assets in the portfolio; no internally sourced assets

- Additionally, all UITs under the Alaia Market Linked Trust provide:

Liquidity	NAVs to be disseminated on a daily basis. All UITs have daily contractual redemptions at their NAV
Transparency	All portfolio assets as well as all cost and expenses within the UIT are fully transparent, including individual asset prices on the initial deposit date

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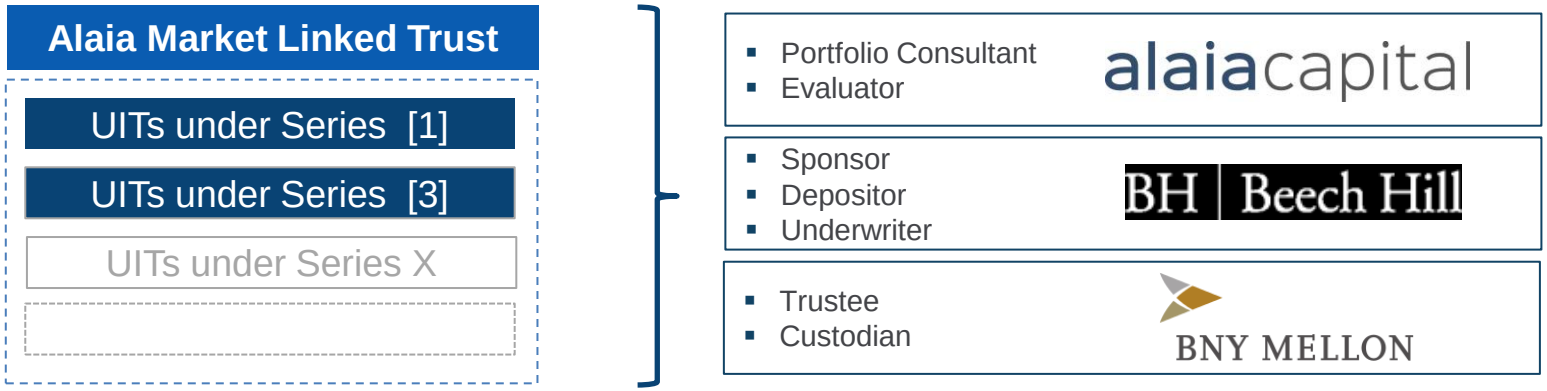
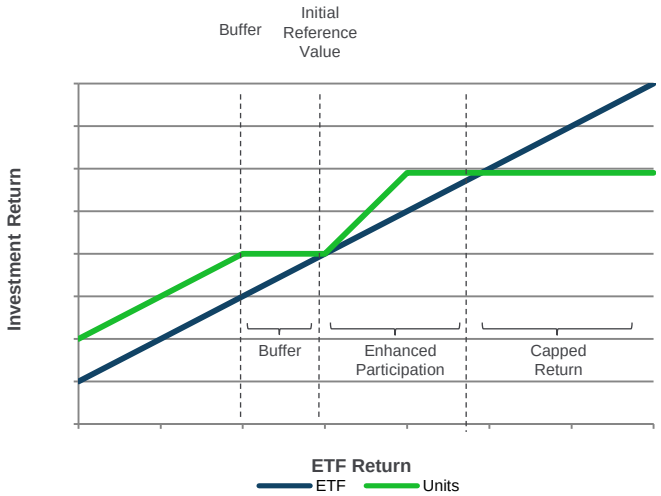
Alaia Market Linked Trust Framework



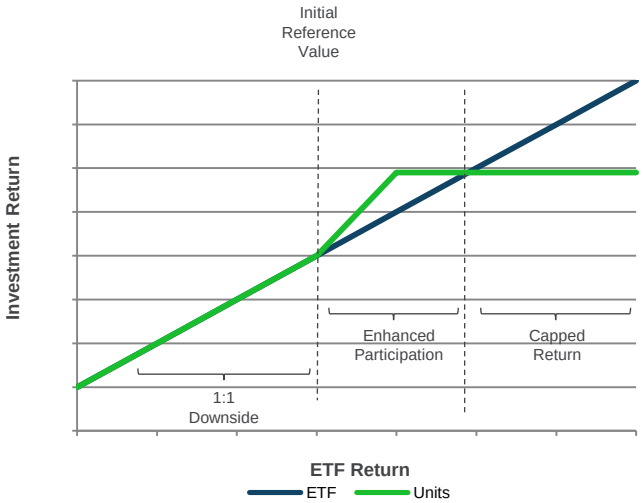
- Series [1] allows for "Enhanced" returns, up to a "Cap" and provides a downside "Buffer", all linked to an ETF or index. Levels of "Enhancement", "Caps", "Buffers" and the underlying ETF/index can all be modified
- Series [3] allows for "Enhanced" returns, up to a "Cap" with 1:1 downside
- The Alaia Market Linked Trust intends to deliver additional Series that will be focused on different types of outcome driven objectives from those covered in Series [1] & [3]

Payoffs Available

- Buffered Return
  - *Series [1] allows for "Enhanced" returns, up to a "Cap" with 1:1 downside below a "Buffer"*



- Accelerated Return
  - *Series [3] allows for "Enhanced" returns, up to a "Cap" with 1:1 downside*



- Listed options can be used to create vanilla payoffs, limitations include:
  - No single stock underliers
  - No multi-index underliers such as worst-of's and baskets
  - Limited payoffs requiring exotic options

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Distribution

- Issuances of UITs may be built for (i) syndicate-style broad-based distribution and/or (ii) customized requirements for limited distributions (all subject to expectations of minimum amounts).
  - *UITs can be issued generally with 2 CUSIPs: (i) a CUSIP for brokerage accounts, and (ii) a CUSIP for fee-based accounts*

- Unlike notes which collect all indications of interest prior to trade date, UITs allow for an organizational period (generally up to 90 days) where units can get created on a daily basis at NAV

Channel-Specific Broad Syndication	Multi-Channel Broad Syndication	Customization
• Exclusive offerings tailored for a single distribution channel • Book building designed to resemble monthly calendar offerings	• Broad offerings available for clients in wealth management network • Participation from multiple channels	• One-off customization of terms for a certain minimum size

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Structural Differences Between the Alaia Structured fund Solutions and Traditional Outcome Driven Investments

- Outcome-driven investments have traditionally been accessed via
  - *Structured notes, certificates and CDs*
  - *OTC derivatives*
  - *Certain pooled vehicles & others*

	Hypothetical Attributes of an Alaia Market Linked Trust	US Registered Structured Notes
Format	Unit Investment Trust registered under the 1940 Act. Purchases assets held in custody	Senior unsecured notes registered under the 1933 Act. Debt of an issuer bank/corporation
Governance	Trustee, Portfolio Consultant (Investment Advisor), Sponsor and Evaluator	None - N/A
Term	Definite term	Definite term
Distribution	Syndicate style distribution or one-off customized	Syndicate style distribution or one-off customized
CUSIPs	Brokerage and fee-based	Brokerage and fee-based

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Structural Differences Between the Alaia Structured fund Solutions and Traditional Outcome Driven Investments

	Hypothetical Attributes of an Alaia Market Linked Trust	US Registered Structured Notes
Credit risk	Limited. Assets will be FLEX listed options (issued by the OCC), and US Treasuries	Senior unsecured credit risk of the issuing bank/corporation
Liquidity	UITs are redeemable daily at NAV via the Trustee	Best efforts, with bid/offer spreads generally.
Pricing	Market-based institutional pricing on all assets	*Derivative pricing:* for some bank issuers, internal derivative hedging *Credit pricing:* funding subject to internal issuer treasury guidelines
Transparency	Backed by assets. Transparency on assets composition and initial pricing, fees and concessions	N/A – notes are not backed by assets. Transparency on concessions

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Alaia Capital Partner Bios

Oscar Loynaz, Co-Founder and CIO

Prior to co-founding Alaia Capital, Oscar was a Managing Director at Citigroup Global Markets in charge of Americas Structuring and Sales of all structured equity and multi-asset solutions for institutional, high net worth and retail clients. Oscar led and managed the efforts to build a broad-based and robust structured business for Citigroup, where he pioneered the structured products platform in the mid 90's and grew the product offering to include quantitative investment strategies, comprehensive structured platforms and wrappers, and MTN trading. Additionally, Oscar was the global head of Multi-Asset Structuring from 2012 to 2013 with teams located in NY, London and HK, as well as the head of Equity Derivatives for Latin America in 2014. Oscar was part of the Equity Derivatives Operating Committee and the Latam Equities Executive Committee.

Oscar was also a Managing Director and head of Multi-Asset Structuring and High Net Worth Sales for the Americas at Bank of America Merrill Lynch prior to joining Citigroup. Oscar managed all structuring and origination, where he and his team were responsible for the creation, delivery and trading of structured solutions for the entire Merrill Lynch advisor base as well as for family offices, ultra-high net worth and institutional clients. Annual notional amounts traded under Oscar's leadership exceeded $17 billion while at BAML.

Oscar started his career on Wall Street at BNP Paribas, were he worked in a structured finance unit responsible for originating and creating structured solutions for corporate clients. He has an MBA from Columbia University, received his Mechanical Engineer degree from Universidad Metropolitana in Venezuela, and holds securities licenses from FINRA in Series 7, 63, and 24. He resides in Greenwich, CT with his wife and 3 kids.

Alaia Capital Partner Bios

Paul Koo, Co-Founder and COO

Prior to co-founding Alaia Capital, Paul was a Managing Director at Citigroup Global Markets where he ran Delta One Sales and Trading for the Americas, which encompassed all swaps and ETF products. Under his leadership, many structural, technological, and operational changes were advanced, leading to a more than doubling of revenue and placing the firm within the top tier among its client base. Paul was also responsible for building a market-leading International Derivatives Sales desk to address a gap in coverage to institutional clients focused on non-US underlying equities. Paul was a member of the Americas Executive Committee and Global Operating Committee for both Equities and Prime Finance divisions. He also served on the Markets Sales and Trading Recruiting Steering Committee.

Before joining Citigroup, Paul was a Managing Director in the Equities division of UBS where he also formed and headed the firm's International Equity Derivatives Sales desk with teams in NY and London, and led initiatives for global Delta One products. Driven by the success of this effort, Paul also was awarded responsibility for Latin America Equity Derivatives sales and trading. Prior to UBS, he also held senior management positions at Morgan Stanley and Comstock Partners comprising a variety of functions in research, trading, and sales. Paul started his career in the industry at the Korea Institute of Finance.

Paul graduated from Denison University in 1993 with a B.A. in Economics, and holds securities licenses from FINRA in Series 7, 63, 3, 4, 55, and 24. He lives in New Canaan, CT with his wife and four children.

Alaia Capital Partner Bios

Stephen Bodurtha, Business Development

Steve has spent his career building and transforming investment and wealth management businesses. As the head of Citi Private Bank's investment business in North America, Steve led its transformation from a banking and lending dominated business and culture to a leading provider of investment and wealth services to ultra-high net worth clients. This organization was recognized as the "Best Private Client Investment Platform" by the 2015 and 2016 Family Wealth Report Awards.

Prior to joining Citi Private Bank in 2009, Steve co-headed the investments, wealth management and insurance organization, as well as the retirement business, at Bank of America Merrill Lynch. He began his career with Merrill Lynch in investment banking and held multiple leadership roles in the firm's institutional and wealth management divisions over two decades.

Steve has been a leading innovator in investment and wealth services and a builder of strong professional teams. He is a co-creator of the $80+ billion Sector Spdrs exchange traded funds, and led the development of open architecture trading methods for the benefit of investors. He hired the first chief investment officer in the wealth management division of Merrill Lynch, delivered recognized innovations in asset allocation, and launched the firm's first unified multi-product, multi-asset class managed account platform. Steve has published articles in books and periodicals such as *The Financial Analysts Journal*. He was also featured in an HBS case study in Investment Management, and in the book, *The Super Traders*.

Steve has an MBA from Harvard Business School, where he also wrote cases. He graduated *magna cum laude* from Wesleyan University with a BA in Government.

Alaia Capital Partner Bios

Daniel Yang, CFA, Sales and Marketing

Prior to joining Alaia Capital, Dan worked in the Securities Division at Goldman Sachs managing a strategy to build and expand a structured notes franchise in commodities and foreign exchange. As a member of Interest Rate Product Sales, he also priced, marketed, and executed structured rate debt instruments to US Broker Dealers, Goldman Sachs Private Wealth Management, and Registered Investment Advisors (RIA).

Before joining Goldman Sachs, Dan was a Director in the Corporate & Investment Bank at Barclays beginning in 2009. As a senior member of Equity & Fund Solutions, he collaborated with a diverse range of institutional clients on cross-asset structured notes and derivative solutions. His group consistently originated over $5 billion annually in notes, exchange traded products, and over-the-counter (OTC) derivatives linked to equities, interest rates, commodities, and currencies, including fund-linked and algorithmic strategies. During this time he also oversaw OTC interest rate solutions for high net worth clients of Barclays Wealth, assessing their interest rate risk and advising on hedge implementations. His range of clients consisted of top tier brokerage firms, family offices, RIA's, foundations, and endowments. Dan started his career in fixed income at Morgan Stanley in 2000, working in the capital markets group of Global Wealth Management before eventually holding roles in interest rate structuring and equity derivative sales within the firm's Institutional Securities Group. There he tailored customized structured notes and advised clients on derivative hedging and investment strategies for concentrated equity positions.

Dan received his Bachelors in Science with a concentration in Finance from the University of Florida. He is a Chartered Financial Analyst and holds securities licenses from FINRA in Series 7, 63, 3, and 55. He resides in New York City with his wife and child.

Alaia Capital Partner Bios

Steve Houston, Business Development

Steve joined Alaia Capital in April, 2017 and is responsible for business development activities. He has over 28 years of industry experience having worked primarily in both the Wealth Management segments and in Capital Markets/Derivatives businesses.

Steve started his career with PaineWebber working in the Mortgage-Backed Securities group. He then joined Bankers Trust Company in the Fixed Income Derivatives group and spent approximately 7 years with the firm being located in both New York and Hong Kong. Steve then spent ten years with Merrill Lynch where he worked in both New York and in Tokyo. While at Merrill he ran the firm's Private Client Structured Investments business, as well as, the firm's Private Client Alternative Investments business.

Steve was then recruited by Barclays Bank to oversee their Americas Wealth Management business. Steve spent 6 years with Barclays during which time he was also appointed to the Board of Directors of Barclays Capital Inc. (the operating company under which all US based employees worked). At the end of 2015, Steve played a key role in executing the sale of his division (the Americas Wealth Management business) to Stifel Financial for whom he then spent approximately 1 year working for, prior to joining Alaia Capital.

Steve holds his undergraduate degree from the University of Texas and his MBA from Columbia University. He lives in Old Greenwich, CT and is married with three children.

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SALES OF UNIT INVESTMENT TRUSTS AND DISCHARGING FIDUCIARY DUTIES

BACKGROUND

In April 2016, the U.S. Department of Labor ("DOL") adopted rules that significantly expanded the scope of persons who would be deemed fiduciaries when dealing with retail retirement accounts (the "DOL Fiduciary Rule").[1] Any person deemed a fiduciary would generally be prohibited from receiving commissions or other forms of variable compensation when selling securities to a retail retirement account. Concurrent with the adoption of the DOL Fiduciary Rule, the DOL approved two new exemptions that would permit fiduciaries to continue to receive commissions in transactions with retail retirement accounts.[2]

- Fiduciaries may not be paid a commission when selling to retail retirement accounts unless the sale fits within an applicable exemption.
- The Principal Transactions Exemption applies to sales made on a principal basis but only applies to a limited range of investment products.
- The Best Interest Contract Exemption ("BIC Exemption") is available for most investment products but only applies to sales made on an agency basis.

PRINCIPAL TRANSACTIONS EXEMPTION

The Principal Transactions Exemption is available for transactions effected on a principal basis. However, it is only available for limited categories of securities and investment products.

The following securities may be sold under the Principal Transactions Exemption:

- Unit investment trusts ("UITs");
- Certificates of deposit ("CDs"); and
- "Debt Securities," which term is defined to mean:
  - U.S. dollar-denominated debt securities issued by a U.S. corporation and sold in a registered offering;
  - U.S. Treasury securities;
  - U.S. Agency securities; and
  - Asset-backed securities guaranteed by a U.S. Government agency or a GSE.

A financial institution selling products in reliance on the Principal Transactions Exemption must adhere to impartial conduct standards. Compliance with the impartial conduct standards requires that the financial institution:

- Act in client's best interest;
- Comply with best execution; and
- Provide full and fair disclosure.

Determining that a proposed investment meets the impartial conduct standard will require the financial institution to evaluate product risk, liquidity and costs. In addition, as noted above, financial institutions must comply with certain contract and disclosure requirements specified in the Principal Transactions Exemption.

Additional requirements are imposed on the sale of Debt Securities, but not on the sale of UITs; for example, for Debt Securities:

- The Debt Securities cannot have been issued by the financial institution or any affiliate of the financial institution
- The financial institution cannot act as an underwriter
- Debt Securities can have no more than a moderate degree of credit risk
- Debt Securities must be sufficiently liquid to be sold at or near their carrying value in a reasonably short period of time

These restrictions apply to structured notes, rendering reliance on the Principal Transaction Exemption in the context of structured notes quite challenging. None of these restrictions apply in the case of UITs.

[1] Retail retirement accounts refers to ERISA plans and IRA accounts that are not managed by an independent bank, insurance company, broker-dealer, investment adviser or other professional fiduciary with at least $50 million under management.
[2] The DOL Fiduciary Rule became effective in June 2016, with initial compliance required by April 10, 2017. A number of legal challenges and other orders may result in a delay or a repeal of the DOL Fiduciary Rule.

UITs VS. DEBT SECURITIES *(in the context of the Principal Transactions Exemption)*

Feature	UITs	Debt Securities
May sell through an underwritten offering	Yes	No
May possess no more than moderate credit risk	N/A	No
Must be sufficiently liquid to sell at or near carrying value within a reasonably short period of time	N/A	Yes

BEST INTEREST CONTRACT EXEMPTION

The BIC Exemption is available for the sale of most categories of securities and investment products. However, it is not available when the financial institution selling the security to the retail retirement account is acting as a principal; it is only available for transactions effected on an agency or riskless principal basis.

The BIC Exemption defines "principal transactions" to include any purchase or sale for the account of the financial institution or any of its affiliates (other than riskless principal transactions). The BIC Exemption is only available for transactions effected on an agency or riskless principal basis. The sale of a product, such as a structured note, for the account of the financial institution or any of its affiliates would be deemed a "principal transaction" not eligible for the BIC Exemption. A "riskless principal transaction" is defined as any transaction where the financial institution, after receiving an order from a client for an investment product, purchases or sells the same product for its own account to offset the contemporaneous transaction with the client. Among other things, in order to comply with the BIC Exemption, the financial institution must:

- Adhere to impartial conduct standards;
  - Act in the best interest of the retirement investor;
  - Not charge any unreasonable compensation;
  - Make certain disclosure regarding the recommended transaction, fees, compensation and material conflicts of interest, which disclosures must not be misleading;
- Enter into contract with the retirement investor pursuant to which it will acknowledge its fiduciary status; and
- Meet disclosure requirements.

The BIC Exemption is available for the sale of proprietary products, but significant additional requirements are imposed.

IMPLICATIONS FOR STRUCTURED PRODUCTS

Traditionally, structured products have been sold in the United States principally by bank holding companies or their affiliates pursuant to SEC-registered offering programs. Recently, innovations in the structured products industry have allowed alternative delivery mechanisms to emerge, notably 40 Act-registered UITs that have as their investment objective a traditional structured payoff normally made available through a structured note. 2016 saw the launch of the first structured UIT platform (the Alaia Market Linked Trust).

Structured notes that would not qualify for sale under the Principal Transactions Exemption (whether because they would not meet the credit and liquidity standards or because they are not SEC-registered) could still be sold in compliance with the BIC exemption. However, under the BIC Exemption the sales must be effected on an agency or riskless principal basis. These requirements are onerous and generally necessitate changes to the traditional distribution arrangements for structured notes. By contrast, structured UITs may be sold in reliance on the Principal Transactions Exemption without having to meet the credit and liquidity standards required for Debt Securities. Of course, a financial institution selling any investment product will need to consider creditworthiness and liquidity issues when evaluating whether the product is in the client's best interest. In this regard, the daily contractual liquidity built in to structured UITs and the very marginal inherent credit risk in them should facilitate a conclusion that the product is in the best interest of the client.

STRUCTURED UITs IN DISCRETIONARY ACCOUNTS

Setting aside the application of the DOL Fiduciary Rule, broker-dealers and registered investment advisers might nonetheless favor structured UITs over alternative products for a number of reasons:

- UITs are an efficient and low cost way to invest in a structured payoff through a portfolio of securities (compared to relying on the credit of a structured note issuer);
- UITs incur no ongoing trading costs and incur limited ongoing administration costs;
- UIT portfolios and fees are entirely transparent;
- The UIT's have daily contractual liquidity and NAV dissemination;
- A qualified investment professional constructs the UIT's portfolio and along with the sponsor can seek best execution; and
- The protections of the 1940 Act available to investors.

Summary-Advantages/Disadvantages

	Unit Investment Trust	Closed End Fund	Repackaging (Grantor Trust)	Custodial Arrangement/Receipt
Assets	"Securities" as defined under the 1940 Act.	"Securities" as defined under the 1940 Act.	"A discrete pool of receivables or other financial assets . . . that by their terms convert to cash in a finite period."	Usually equity securities but can be any assets.
Accounting	Not consolidated	Not consolidated	Generally consolidated.	Not consolidated
Time to register initially	Approx. 2 months, requires SEC review	Approx. 2 months, requires SEC review	Approx. 2 months, requires SEC review.	Approx. 2 months; would be considered "novel" product.
Time for subsequent deals	Up to 2 weeks (each deal must be submitted to SEC, though not reviewed)	Up to 1 week.	Up to 1 week.	Approx. 2 months.
Ongoing cost	Front-ended	Ongoing administrative costs	Minimal ongoing cost	Minimal ongoing cost
Who reviews at SEC?	Investment Management (40 Act)	Investment Management (40 Act)	Corporation Finance	Corporation Finance
Disclosure requirements	More flexible	More flexible	Morgan Stanley letter-type disclosure	Morgan Stanley letter-type disclosure
Rating	Not required	Not required	Required	Not required
Familiar to investors?	Yes	Yes	Yes	Yes
Investor perception	Viewed as 1940 Act product	Viewed as 1940 Act product	More akin to a "securitization"	Novel product
"Suitability"	Need to consider	Need to consider	Need to consider	Need to consider
Desirable tax treatment?	If a grantor trust, yes	No, because RIC requires diversification	Yes	Yes
Flexibility in contracting with third parties	Only as part of initial set-up.	Subject to prohibition on affiliated transactions	Yes	Yes
Redemption/like kind	Must be redeemable	Not required	Not required	Yes, for underlying assets
Secondary market	Yes	Yes	Yes	Yes

	Unit Investment Trust*	Closed End Fund	Repackaging (through Grantor Trust)	Custodial Arrangement/Receipt
Summary/Overview				
Entity Type	Trust with fixed life	Corporation.	Trust with infinite life (may be structured as separate trusts, or as a master trust.	Trust with fixed life
Securities law purposes: 1940 Act Registered	Yes.	Yes.	No, exempt from 1940 Act (3a-7).	No, exempt from 1940 Act (no-action letter relief)
Tax classification	May be a RIC for tax, or a grantor trust	RIC	Grantor trust/pass through	Agency
Publicly Offered Security	Units that represent an "undivided interest in a unit of specified securities."	Common stock, preferred stock and debt.	Equity/debt. If equity, then pass-through trust certificates representing an interest in the trust.	Custodial or trust receipts representing a 100% interest in one or more underlying securities
Minimum Investment/Purchaser Qualification	Publicly registered. None required for investors purchasing in the open market.	Publicly registered. None.	Publicly registered. None.	Publicly registered. None, provided none exists for underlying securities.
Fixed or Managed Investment	A UIT must have a fixed investment portfolio for the duration	A closed-end fund may have a managed portfolio. Changes to investment policy may require shareholder approval, or disclosure.	The trust will have fixed investments, though provisions may exist for removal/substitution under certain limited circumstances.	The trust must have a fixed investment portfolio, though weightings may change over time, and corporate events may necessitate removal.
Ability to Withdraw Underlying Assets	Section 4(2) of the 1940 Act requires that a UIT issue only redeemable securities. Securities can be redeemed for NAV less applicable expenses.	A closed-end fund is not required to issue redeemable securities.	Trust certificates generally are not redeemable.	SEC relief focused on holders' ability to withdraw the underlying securities at any time, subject to only a moderate fee. Receiptholders possess all indicia of ownership.
Distribution of Income	Required	Required	Required.	Required.

* May be a RIC or a grantor trust for tax purposes.

	Unit Investment Trust*	Closed End Fund	Repackaging (through Grantor Trust)	Custodial Arrangement/Receipt
Diversification	Not required.	Required.	Not required.	Not required.
Tax Treatment				
Tax at Entity Level	If grantor trust, no. If RIC, no, so long as it distributes 100% of taxable income annually.	No, so long as it distributes 100% of taxable income annually.	No.	No.
Flow Through of Tax Character of Underlying	If grantor trust, yes. If RIC, no.	No.	Yes.	Yes.
If entity enters into straddle and therefore has only short-term capital gains, can investor get long-term capital gains on sale?	If grantor trust, no. If RIC, yes.	Yes.	No.	No.
Long-term capital gain on liquidation at maturity?	If grantor trust, no. If RIC, yes.	Yes.	No.	No.
Sales Issues				
Registration	Rule 487 permits each series of UIT (with different underlying securities) to be declared effective automatically. Must establish that SEC has reviewed original series, that the underlying securities do not differ materially and disclosure in the new series does not differ materially. Rule 487 requires a new registration statement each time.	No shelf form for 1940 Act registered issuers. No action relief (Pilgrim, Nuveen) permits registration on Form N-2 and takedowns using a prospectus supplement.	May register on Form S-3. Form SF-3 is for use in connection with continuous or delayed offerings of investment grade asset-backed securities.	Must register on Form S-1.

	Unit Investment Trust*	Closed End Fund	Repackaging (through Grantor Trust)	Custodial Arrangement/Receipt
	No shelf form for 1940 Act registered issuers.			
Distribution	Single, firm commitment offering of a fixed size (not ongoing). Depositor receives the units after making initial deposit and then distributes to the public.	Single, firm commitment offering of a fixed size (not ongoing). Fund sells securities directly to the public in an underwritten offering.	Single, firm commitment offering of a fixed size (not ongoing). Trust sells trust securities directly to the public, in an underwritten offering.	Single, firm commitment offering of a fixed size (not ongoing). Trust sells receipts directly to the public, in an underwritten offering.
Secondary Sales	Unitholders may sell their securities at any time. Sponsors generally maintain secondary market (at market prices). Must deliver a prospectus with secondary sales. Must keep registration statement current.	Common stock is listed and can be sold at any time on the secondary market. Underwriters may maintain a secondary market for preferred stock and debt. Must deliver a prospectus with secondary sales. Must keep registration statement current.	Holders may sell their securities at any time. Prospectus delivery not required, but registration statement must be kept current.	Receiptholders may sell their securities at any time.
Prospectus Delivery	Not able to rely on access equals delivery.	Not able to rely on access equals delivery.	Access equals delivery.	Access equals delivery.
Sales Charge/Compensation	Includes an initial sales charge and minimal ongoing trustee's and sponsor's fees. Brokerage fees and commissions apply to purchases in the secondary market.	Underwriters, placement agents and sub-dealers and sub-agents usually receive commissions (or reallowances) in connection with initial issuance. Limits on front-end, back-end and asset based sales charges under FINRA rules. Must engage an investment adviser. Advisory contract requires specific content, approval and annual renewal.	Underwriters, placement agents and sub-dealers and sub-agents usually receive commissions (or reallowances) in connection with initial issuance. Brokerage fees and commissions apply to purchases in the secondary market.	Underwriters, placement agents and sub-dealers and sub-agents usually receive commissions (or reallowances) in connection with initial issuance. Brokerage fees and commissions apply to purchases in the secondary market.

	Unit Investment Trust*	Closed End Fund	Repackaging (through Grantor Trust)	Custodial Arrangement/Receipt
		Performance fees are permissible under tight limits.		
Securities Law Issues				
Disclosure	A UIT must register using Form N-8B-2, which requires extensive disclosure about the description of the securities, sales loads and fees, information regarding the sponsor, distribution and redemption arrangements, tax consequences and audited financials. Each series of a UIT must register on Form S-6 that contains the information that would be required in a Form N8-B2 and financial statements. Initial S-6 is treated like the initial offering of an investment company, including SEC review.	A closed end fund must register on Form N-2, which requires extensive disclosure about the description of the securities, sales load and fees, information regarding the sponsor, investment adviser, distribution and redemption arrangements, tax consequences and audited financials. A statement of additional information also with extensive and specific disclosure requirements also is required.	A depositor/sponsor must comply with Reg AB II disclosure requirements, including risk factors, description of the certificates, plan of distribution, information regarding underlying assets, servicers, trustees and others, and tax consequences. If any one issuer's securities make up 10% or more of the pool, issuer is a significant obligor and subject to disclosure requirements, among other things.	A sponsor must comply with the disclosure requirements of Form S-1, including risk factors, description of the receipts, plan of distribution, information regarding the underlying securities, the trustee and tax consequences.
Reporting	Required to provide annual reports to unitholders.	Required to file annual and semi-annual shareholder reports. Also required to file quarterly reports on holdings.	Required to file annual reports on Form 10-K and reports on Form 10-D (in connection with a distribution) as well as periodic reports on Form 8-K.	Trust is required to register receipts with the SEC and to file periodic reports upon a change in the underlying asset (such as stock split, if stock).
Sarbanes-Oxley Requirements	Not applicable.	Closed-end funds are required to file an N-CSR twice yearly with annual and semi-annual shareholder reports. Includes certain certifications and disclosures.	Section 302 certifications required (signed by person signing Form 10-K)	Not applicable.
Performance	FINRA requires	Requirements for calculation,	Computational material may	Not applicable

	Unit Investment Trust*	Closed End Fund	Repackaging (through Grantor Trust)	Custodial Arrangement/Receipt
Advertising	communications about performance based on NAV to give equal prominence to performance based on closing market price. UITs may not rely on estimated current return; instead should also rely on estimated long-term return.	format and disclosure of performance are spelled out in Form N-2 and related SEC rules and FINRA rules. Subject also to detailed guidance in no-action letters applying general anti-fraud provisions.	include statistical information such as the yield, average life, expected maturity, interest rate sensitivity, cash flows, etc. for a class of securities	
Anti-fraud Requirements	Subject to the anti-fraud provisions of the 1940 Act, 1933 Act and 1934 Act.	Subject to the anti-fraud provisions of the 1940 Act, 1933 Act and 1934 Act.	Subject to the anti-fraud provisions of the 1933 Act and 1934 Act.	Subject to the anti-fraud provisions of the 1933 Act and 1934 Act.
Compliance Issues				
Affiliated Transactions	Principal transactions (sales of securities or other property or loans from the UIT to the Sponsor or other affiliates or vice versa) are flatly prohibited. Sponsor permitted to act as underwriter (purchases and holds the securities making up the portfolio) and to maintain unitholder records. Sponsor may receive a fee for providing portfolio supervisory services. Section 26 of the 1940 Act limits fees payable.	Principal transactions (sales of securities or other property or loans from the fund to the adviser or other affiliates or vice versa) are flatly prohibited. Agency transactions with affiliates are permitted subject to board review and limits on the level of commissions. Cross transactions (between funds or between fund and another account managed by the adviser) mostly are treated as principal trades but generally are treated under SEC rules.	Not subject to Section 17 of the 1940 Act. Must describe how the sponsor, depositor or issuing entity is an affiliated of: the servicer, trustee, a significant obligor or the provider of credit enhancement, as well as a description of any material business relationship/arrangement outside the ordinary course.	Not subject to Section 17 of the 1940 Act.
Pricing/Valuation	UITs calculate NAV once a day. For listed UITs, investors can buy and sell on an exchange at the prevailing market price, which may be at	Pricing determined by secondary market.	Pricing determined by secondary market.	Pricing determined by secondary market.

	Unit Investment Trust*	Closed End Fund	Repackaging (through Grantor Trust)	Custodial Arrangement/Receipt
	a premium or discount to NAV, but which generally tracks the approximate value. Performance disclosed based on NAV and market price.			
Board or Other Independent Oversight	A UIT is defined under Section 4(2) of the 1940 Act as not having a board of directors. Requires only minimal supervision by the sponsor and a trustee to administer the assets.	Must have a board of directors satisfying statutory independence requirements (a majority independent).	Not required to have a board of directors. Minimal supervision by sponsor and trustee to administer the assets.	Not required to have a board of directors.
Code of Ethics	Under the 1940 Act, must adopt a code of ethics (provisions reasonably necessary to prevent unlawful conduct). Must be approved by principal underwriter.	Under the 1940 Act, must adopt a code of ethics and reporting by covered persons.	Not required.	Not required.
Fiduciary Duty	As specified by the regulations applicable to the trustee, usually a banking institution.	Express duty with respect to receipt of compensation from the fund, and fees are subject to board oversight. Other duties as required by the Investment Advisers Act.	As specified by the regulations applicable to the trustee, usually a banking institution.	As specified by the regulations applicable to the trustee, usually a banking institution.
Management	Passive	Active	Passive	Passive

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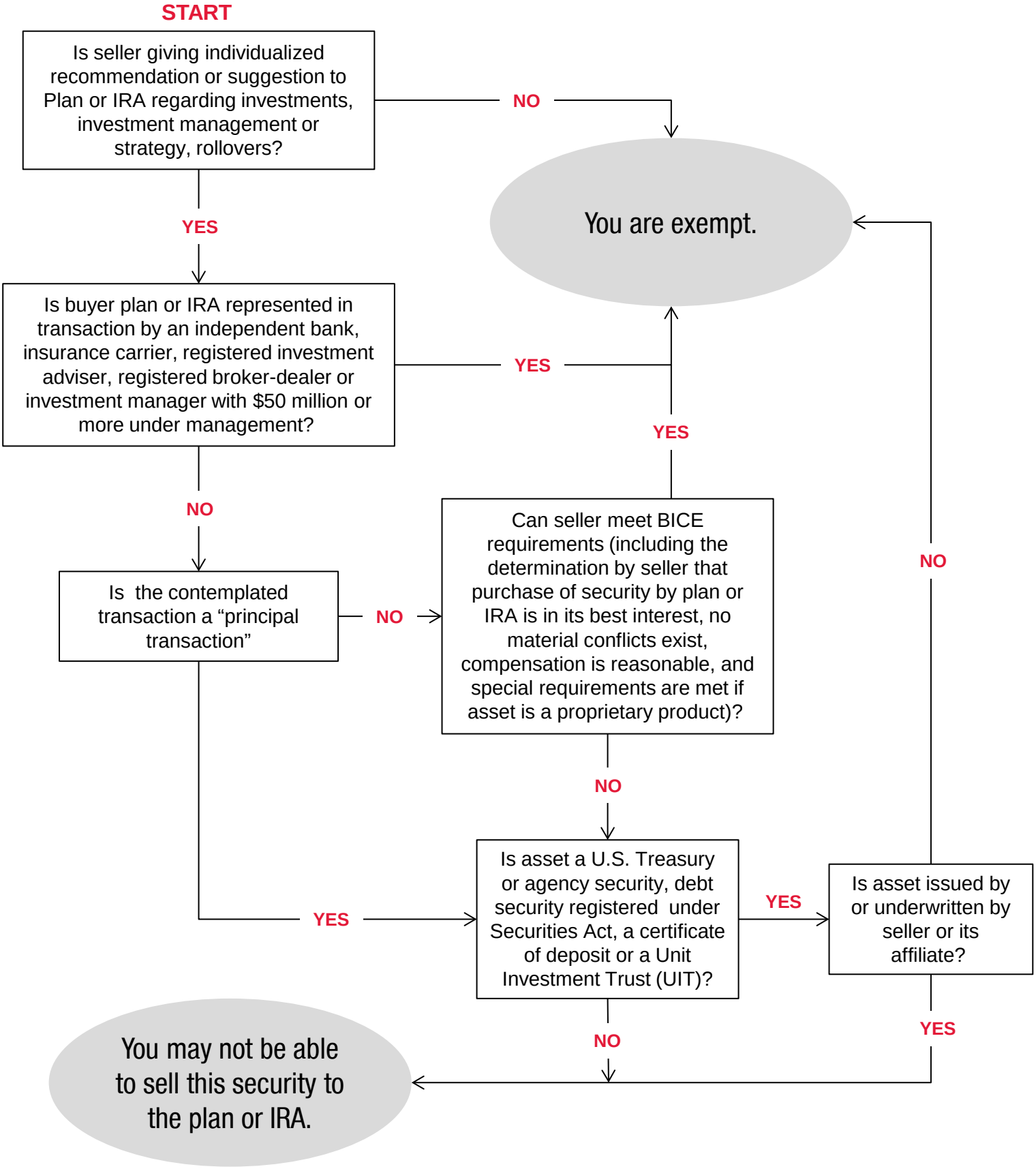
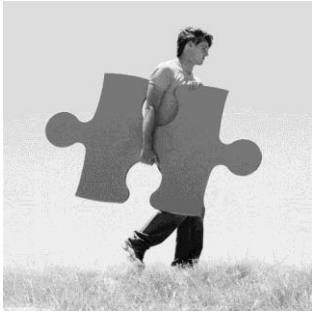
Summary of DOL Conflict Rule, BICE and Principal Transaction Exemption



Client Alert

April 5, 2017



DOL Fiduciary Rule Delayed by 60 Days

Impartial Conduct Standards to Become Effective on June 9, 2017

Other Provisions Are Subject of Further Evaluation Prior to January 1, 2018 Implementation Date

Late in the day on April 4, 2017, the Department of Labor ("DOL") made publicly available its final rule, extending by 60 days the implementation of its fiduciary rule adopted in April 2016 (the "Fiduciary Rule"). The final rule is expected to be published in the Federal Register on April 7, 2017, and will become effective immediately upon publication, one business day before the Fiduciary Rule was scheduled to become applicable. The pre-publication text is available on the DOL website.[1]

Although the 60-day delay had been widely anticipated, the final rule includes some important provisions, which will impact market participants in the near future:

- There will be no delay beyond June 9, 2017 for the expanded definition of "fiduciary" set forth in the Fiduciary Rule.
- Fiduciaries will be required to comply with the Impartial Conduct Standards (summarized below) starting on June 9, 2017.
- DOL acknowledged that 60 days will likely be insufficient for it to conduct the review of the Fiduciary Rule ordered by President Trump. However, it anticipates completing that review prior to the scheduled implementation date for the remaining aspects of the Fiduciary Rule (January 1, 2018.)

Background

In April 2016, the DOL published the Fiduciary Rule, which became effective in June 2016. Implementation of the Fiduciary Rule was originally deferred to April 10, 2017, with many of the provisions not becoming applicable until January 1, 2018.[2]

On February 3, 2017, President Trump issued an executive memorandum directing DOL to further study the Fiduciary Rule and to take corrective action if it concludes that the rule harms retirement investors or has certain other adverse effects.

The Fiduciary Rule significantly expands the categories of persons who might be deemed "fiduciaries". Under the expanded definition, a single instance of providing advice to a retail retirement investor[3] regarding specific investments, investment strategies, or investment advisers could be sufficient to trigger fiduciary status. The expanded definition would likely sweep in most broker-dealers and many insurance agents.

[1] *See* https://s3.amazonaws.com/public-inspection.federalregister.gov/2017-06914.pdf.
[2] *See* our prior Client Alerts: https://media2.mofo.com/documents/160407erisa.pdf; https://media2.mofo.com/documents/161031-dol-guidance-fiduciary-rule.pdf.
[3] There is an exception from the Fiduciary Rule for advice provided to retirement investors who are represented by independent, professional fiduciaries.

Persons and firms who are deemed fiduciaries must act in the best interest of their clients. Moreover, they are generally prohibited from engaging in transactions with clients that involve a conflict of interest or from receiving variable compensation, such as sales commissions. These requirements pose major challenges for many broker-dealers who regularly engage in principal transactions with their customers and who compensate their sales force on a commission basis.

Recognizing this dilemma, the DOL adopted with the Fiduciary Rule two new prohibited transaction exemptions ("PTEs")—the Best Interest Contract Exemption and the Principal Transactions Exemption.[4] These new PTEs would enable broker-dealers to continue to earn commissions on a wide range of securities transactions effected on an agency or riskless principal basis, and would have permitted them to continue to act as a principal with respect to a rather narrow range of investment products. However, both exemptions include detailed contractual and disclosure requirements, which have raised concerns about the difficulties of compliance and the risk of exposure to litigation.

Fundamental to the Fiduciary Rule is the requirement that all fiduciaries comply with the Impartial Conduct Standards. These standards require the fiduciary to:

- Act in the Best Interest of the retirement investor;
- Avoid excessive compensation; and
- Refrain from any false or misleading disclosures.

Acting in the "Best Interest" of the retirement investor requires the fiduciary to provide advice that reflects the care, skill, prudence, and diligence that a prudent person would use. The advice must be based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor and must be furnished without regard to the financial or other interests of the fiduciary.

Proposal to Delay the Implementation Date

In light of the Presidential memorandum directing the DOL to further study the effects of the Fiduciary Rule, on March 2, 2017, the DOL published a proposed rule extending the applicability date of the Fiduciary Rule by 60 days, from April 10, 2017, to June 9, 2017. The DOL received more than 193,000 letters commenting on this proposal. The comments covered a wide range of opinions on the need for delay as well as on the merits of the Fiduciary Rule itself.

Following its review of the comments, the DOL concluded that a delay in implementation was appropriate. However, the DOL stated that "*it is inappropriate to broadly delay application of the fiduciary definition and Impartial Conduct Standards for an extended period in disregard of the previous findings of ongoing injury to retirement investors.*" In this regard, the DOL noted that the principles set forth in the Impartial Conduct Standards were not the subject of substantial controversy.

The DOL stated that it would likely require more than 60 days to fully evaluate the detailed requirements of the Best Interest Contract Exemption and the Principal Transactions Exemption. It observed that, since these provisions were not scheduled to become applicable until January 1, 2018, it expected it could complete its review before that date. Accordingly, the DOL states in the final rule:

"Thus, the fiduciary definition in the rule (Fiduciary Rule or Rule) published on April 8, 2016, and Impartial Conduct Standards in these exemptions, are applicable on June 9, while compliance with the remaining conditions in these exemptions, such as requirements to make specific written disclosures and representations of fiduciary compliance in communications with investors, is not required until January 1, 2018."

[4] The DOL also amended a number of existing PTEs to make conforming changes.

Implications of the Final Rule

Financial institutions now have a clear mandate: On June 9, the expanded definition of fiduciary will go into effect, as will the requirement to comply with the Impartial Conduct Standards. Many financial institutions have taken the position that the principles set forth in the Impartial Conduct Standards are appropriate and have planned to implement them regardless of the status of the Fiduciary Rule. Now, all financial institutions whose conduct comes within the scope of the expanded definition of fiduciary will need to be prepared to implement the Impartial Conduct Standards. In many cases, this will require training of sales and supervisory personnel on the distinctions between the suitability standard and the best interest standard. In addition, it will require financial institutions to carefully consider their product mix and their internal compensation systems in order to ensure that they are not misaligned with the best interests of retail retirement investors.

Compliance with the more onerous requirements set forth in the Best Interest Contract Exemption and the Principal Transactions Exemption may be deferred, pending the DOL's continuing review of these provisions. Hopefully, that review will result in modifications to the PTEs that will make them less problematic, and provide more certainty as to how to apply them in specific circumstances. Broadening the scope of permitted principal transactions and eliminating the prohibition on class action waivers are among the changes most needed.

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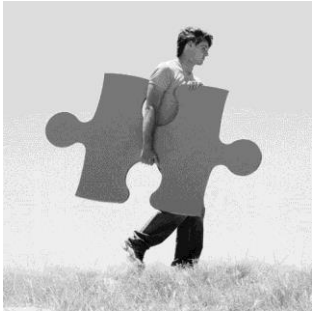
Client Alert

January 23, 2017



DOL Issues Additional Guidance on Fiduciary Rule

On January 13, 2017, the U.S. Department of Labor ("DOL") issued a second set of guidance on its new fiduciary rules, which are scheduled to become effective on April 10, 2017. The guidance was issued in the form of FAQs ("FAQs") and is the second round of guidance to be published by the DOL prior to the effective dates of the new rules.[1] Earlier in January, the DOL issued FAQs directed at consumers instead of practitioners that contain general information about the new fiduciary rules.[2]

Background

In April 2016, the DOL issued a regulation[3] (the "Regulation") that greatly expanded the scope of persons who would be deemed fiduciaries under ERISA[4] and the Internal Revenue Code (the "Code") when dealing with retirement plans and IRAs. As revised, any broker-dealer or financial intermediary, including individual advisers or registered representatives employed by them ("Financial Institution") that makes any suggestions as to how or where a retirement investor should invest may be a fiduciary. Given the prohibitions under ERISA and the Code regarding self-dealing by fiduciaries, the expanded definition effectively proscribes the use of commissions and other variable compensation in dealings with retail retirement investors unless the transaction can fit into an available exemption.

Of particular interest when dealing with retail retirement investors are two new exemptions released by DOL in April 2016: the Best Interest Contract Exemption ("BIC Exemption") and the Principal Transactions Exemption ("Principal Exemption"). The DOL's first set of FAQs, issued on October 27, 2016, addressed a number of issues under those exemptions.[5]

The latest round of FAQs do not address the exemptions that accompanied the Regulation, but rather speak to a number of exceptions to the Regulation, such as (a) communications that are not considered recommendations that would be subject to the Regulation, (b) non-fiduciary investment education communications, (c) non-fiduciary general communications, (d) communications that qualify for the seller's carve-out, and (e) communications that qualify for the platform exception to the Regulation.

[1] https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-2.pdf
[2] https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/consumer-protections-for-retirement-investors-your-rights-and-financial-advisers.pdf
[3] http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806
[4] The Employee Retirement Income Security Act of 1974, as amended.
[5] See our earlier client alert on the first set of DOL FAQs: https://media2.mofo.com/documents/161031-dol-guidance-fiduciary-rule.pdf

Guidance from the FAQs

The FAQs address a number of important topics as summarized below.

(a) What Communications are Considered "Recommendations"?

In general, under the Regulation, a person making a "recommendation" to a retirement plan investor for a fee is considered an investment fiduciary to that plan. The FAQs confirm the formulation in the Regulation that a "recommendation" is a communication that, based on its content, context, and presentation, is a "call to action" that would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular investment-related course of action, such as buying, holding, or selling a particular investment, or as a recommendation on managing investments or investment accounts. Q&A 1.

Financial Institutions and Employees of Financial Institutions. The FAQs provide that internal communications that Financial Institutions make to their own employees in their capacities as employees are not considered recommendations. Q&A 2. By the same token, employees working for a Financial Institution who develop reports, recommendations and products for their employer as part of their normal job responsibilities would not be considered to be giving fiduciary investment advice under the Regulation. Q&A 3. If, however, any such communications were forwarded or made available to retirement investors, an analysis would need to be conducted to determine whether those materials would be considered a recommendation. Q&A 2.

Explanation of Law or Plan Terms vs. Investment Recommendations. The FAQs make clear that explanations by a retirement adviser to a retirement investor of (i) what the law requires with regard to a retirement plan, such as required minimum distributions from the plan, or (ii) what action will be taken under the terms of the plan without the participant's consent, such as the automatic cash-out of small account balances of terminated participants, are not considered fiduciary investment advice. Q&As 4 and 5. However, a recommendation by an adviser as to how any funds distributed from the plan should be invested would be considered fiduciary investment advice. Q&A 4.

Retirement Adviser Not Responsible If Advice Not Followed. The FAQs also clarify helpfully that an adviser is not responsible for any action a retirement investor takes against the recommendation of the adviser. In that instance, however, the FAQs state, under the general fiduciary provisions of ERISA or the adviser's agreement with the retirement investor, the adviser may still have an ongoing responsibility to monitor the retirement investor's investment decisions. Q&A 6.

Retirement Advisers Can Continue to Receive Third-Party Fees under Offset Arrangement. The FAQs confirm that DOL guidance preceding the issuance of the Regulation is still valid. DOL Advisory Opinion 97-15A provided that an adviser may receive revenue sharing or other fees from a mutual fund in which a retirement investor is invested, so long as the agreement between the adviser and the retirement investor expressly provides for a fee offset. Under the fee offset provision permitted by the Advisory Opinion, the agreement between the adviser and the retirement investor must provide that any third-party fees received by the adviser as a result of the retirement investor's investment in the mutual fund would be used to pay all or a portion of the compensation that the retirement investor would otherwise be obligated to pay to the adviser. In addition, the retirement investor would be entitled to any such fees that exceed the retirement investor's liability to the adviser. Q&A 7.

(b) What Communications are Considered Non-Fiduciary Investment Education?

The FAQs also elaborate on the categories of communications that are considered under the Regulation to be educational and non-fiduciary in nature: (i) plan and investment information (e.g., communications describing the investment objectives, risk and return characteristics, historical return information, and related prospectuses of various investment alternatives without specifically recommending any investments); (ii) general financial, investment, and retirement information (e.g. information on standard financial and investment concepts, such as diversification, risk, and return, etc.); (iii) asset allocation models (e.g., information regarding hypothetical asset allocations based on generally accepted investment theories that does not make a specific investment

recommendation); and (iv) interactive investment materials (e.g., questionnaires, worksheets, software to enable workers to estimate future retirement needs).

Information About Plan Terms or Operation vs. Recommendation. The FAQs clarify that a factual explanation of the features of an annuity alternative (such as an optional life income feature) that is provided under a plan would be considered non-fiduciary plan information, as long as the appropriateness of any such feature as an investment is not discussed. Q&A 8. Likewise, *information* given by a call center employee to a retirement investor regarding the benefits of increasing plan contributions in order to maximize a company matching contribution is plan information and not fiduciary advice. Q&A 9. A *recommendation*, however, by an employer that a plan participant increase his or her contributions to a plan in order to maximize the employer matching contribution is not considered investment advice only if, as is almost always the case, the employer does not receive a fee in connection with such communication. Q&A 10. The difference between information and a recommendation is a thin line.

Receipt of Fees Does Not Convert Educational Information into Fiduciary Advice. The FAQs clarify that the receipt of a fee by the provider of general educational information to a retirement investor, including information regarding rollover options, does not convert what is otherwise non-fiduciary educational information into fiduciary advice. Q&A 12. If, however, after providing such educational advice the provider refers the retirement investor to a third party who provides investment advice, and the provider receives a referral fee from the third party, that would be fiduciary investment advice, and also a prohibited transaction, unless the provider were able to avail itself of an applicable exemption. Q&A 13.

Brokerage Window Options Can be Narrowed Without Causing Fiduciary Status. The FAQs state that a plan can offer a limited set of the investments available under a brokerage window (for example 15 investment options out of 2,000 available) and qualify under the asset allocation model prong as non-fiduciary educational information, as long as the retirement investor is provided with information regarding (i) the other investment alternatives in the limited set that have similar risk and return characteristics, and (ii) where information on those investment alternatives may be obtained. Q&A 15.

Interactive Investment Materials. The FAQs provide that a plan service provider's interactive investment tool that requests information from a retirement investor regarding such investor's age, expected retirement date, current retirement savings, annual retirement contributions, etc., that it uses to generate the future retirement income needs of the participant can qualify as educational interactive investment materials and not fiduciary advice. Q&A 11.

(c) What Kinds of Information are Considered Non-Fiduciary General Communications?

Under the Regulation, general communications are not considered fiduciary investment advice if a reasonable person would not view the communication as an investment recommendation. Examples of general communications include general circulation newsletters, television, radio, and public media talk show commentary, remarks in widely attended speeches and conferences, research or news reports prepared for general distribution, general marketing materials, and general market data.

Communications Made at Widely Attended Seminars Not Considered Fiduciary Advice if Individual Retirement Investors Not Allowed to Attend. The FAQs provide an example of a communication that is considered general and non-fiduciary under the Regulation because it is given at a "widely attended" conference. In the example, the conference, sponsored by a broker-dealer, is generally open only to professionals in the retirement industry, including retirement plan fiduciaries, but is not open to individual retirement plan investors. The example provides that the conference has approximately 300 attendees. The FAQs provide that in those circumstances, a speaker's presentation about the features of a 401(k) plan annuity product, including its flexible pricing features, how it can accommodate a variety of broker-dealer compensation structures, and the value it would provide for "many" 401(k) plans, would be considered a non-fiduciary general communication, as long as the speaker's

comments did not purport to be making specific or individualized retirement investment recommendations. Q&A 16.

Communications Made at Dinner Seminars Are Considered Fiduciary Advice. The FAQs provide another example in which a free dinner seminar is given by an investment adviser to potential retirement account clients. The FAQs conclude that such a gathering is not considered a "widely attended" speech or conference that would be considered general and non-fiduciary. The FAQs go on to say that a reasonable person might consider statements made by the investment adviser to be investment recommendations even if the statements were made to all of the attendees. Q&A 17.

Two of the relevant factors in the two contrasting examples appear to be the size of the conference and whether any individual retirement investors are in attendance.

Recommendation to Hire Oneself or a Third Party Non-Fiduciary Not Investment Advice. The Regulation provides that a recommendation to hire a third party to manage securities or other investment property held in retirement accounts is a fiduciary communication. The FAQs clarify that recommendations to a retirement account client to hire a *non-fiduciary* record-keeper is not fiduciary advice, although a recommendation to hire a third party to serve as an asset manager or adviser would constitute fiduciary recommendation. Q&A 18.

In a similar vein, the FAQs provide that a representative of a Financial Institution who explains the services provided by the Financial Institution, and they state that the Financial Institution is a recognized leader in providing high quality services with low fees is not considered to be giving fiduciary investment advice because (i) the Financial Institution through the representative recommended itself, not a third party, to manage retirement account assets, and (ii) the representative did not recommend any particular "account type or service." Q&A 19.

Note: The exception from giving fiduciary advice for recommending oneself is limited to the services that the person would provide and does not extend to a recommendation to purchase any particular retirement investment. The FAQs, without explaining what an "account type or service" in (ii) above is, appears to assume that embodied within an "account type or service" are particular securities with respect to which the representative would be giving fiduciary advice.

(d) How Does the Independent Fiduciary or Seller's Exception Apply?

The Regulation contains an exception to applying fiduciary status to a party who provides investment recommendations to a retirement account, called variously throughout the history of the proposed and final Regulation as "the seller's exception", "the seller's carve-out", or "transactions with independent fiduciaries with financial expertise." One requirement for the applicability of the independent fiduciary exception is that certain disclosures must be made by the investment adviser (who seeks to rely on the independent fiduciary exception) to the retirement account's fiduciary. Another requirement is that the investment adviser must know or reasonably believe that the retirement account fiduciary is a bank, insurance carrier, registered broker-dealer, registered investment adviser, or independent fiduciary who manages or controls at least $50 million.

Establishing the Status of the Independent Fiduciary. The FAQs confirm that in meeting the $50 million under management requirement, amounts can be aggregated from the fiduciary's retirement and non-retirement accounts and from multiple investors. Q&A 20. In addition, the FAQs confirm that the requirements are deemed met if a retirement adviser reasonably relies on representations of the plan fiduciary that it meets those requirements. The FAQs provide that a party could reasonably rely on written disclosures from the plan fiduciary that it manages at least $50 million and will notify the retirement adviser in writing if the amount of investments drops below $50 million. Q&A 21. The FAQs do not address whether "deemed representations" in disclosure documents (e.g., a statement in a disclosure document that a purchaser of the security is deemed to represent that it meets the requirements of the independent fiduciary exception) can be relied on by an adviser for purposes of the independent fiduciary exception.

Broad Application of the Independent Fiduciary Exception. The FAQs confirm that this exception applies to any transaction related to the investment of securities or other investment property, including advice regarding entering into investment advisory and investment management arrangements. Q&A 22. The FAQs also confirm that the exception to fiduciary status applies to communications with a representative of a fiduciary who is a registered investment adviser; provided that the representative is acting under the control and supervision of the registered investment adviser. Q&A 23. Further, the FAQs confirm that the independent fiduciary exception is available to a retirement adviser who gives recommendations to an IRA retirement investor; provided that the IRA is represented by a fiduciary who meets the requirements of the independent fiduciary exception and the retirement adviser reasonably believes that the fiduciary is responsible for exercising independent judgment in evaluating the transaction. Q&A 25.

Individual Retirement Investors May Attend Meetings Between Fiduciary and Adviser. Since the issuance of the Regulation, there has been some question as to whether the independent fiduciary exception requires that the retirement investors who are being protected by the independent plan fiduciary are required to be absent from any meeting between the plan fiduciary and the investment adviser where investment matters are being discussed. Thankfully, the FAQs clarify that the application of the independent fiduciary exception will not be invalidated by the presence of a retirement investor at a meeting with the retirement investor's registered investment adviser fiduciary who meets the requirements of the independent fiduciary exception; provided that the retirement adviser reasonably believes that the registered investment adviser is acting as a plan fiduciary with responsibility for exercising independent judgment in making a fiduciary recommendation to the retirement investor with respect to the transaction at issue. Q&A 24.

Participant in Plan Can be Independent Fiduciary, but IRA Owner Cannot. The FAQs clarify that a corporate officer, who is a participant in a retirement plan sponsored by the corporation, can be a fiduciary that meets the requirements of the independent fiduciary exception; provided that the officer manages at least $50 million, which can consist of a combination of retirement plan and non-retirement plan assets. Q&A 27.

Even though a participant in a qualified plan can be a fiduciary to that plan that meets the independent fiduciary exception, the FAQs clarify that an IRA owner cannot qualify as the fiduciary of his or her own IRA. This somewhat non-intuitive conclusion results according to the FAQs because under the Regulation, an IRA owner is not a fiduciary with respect to the IRA, and so therefore it cannot be an "independent fiduciary" as required under the independent fiduciary exception. Q&A 26.

Requirement that Fiduciary be "Independent." The FAQs discuss the requirement of the independent fiduciary exception that the fiduciary for the plan be "independent", noting that the Regulation does not specifically define "independent", but that the preamble to the Regulation provides that whether a party is independent for purposes of the Regulation will generally involve an analysis of whether there exists a financial interest, ownership interest or other relationship, agreement, or understanding that would limit the ability of the party to carry out its fiduciary responsibility to the retirement investor beyond the control, direction, or influence of other persons involved in the transaction. The preamble to the Regulation further provides that parties would likely not be independent in any of the following circumstances: (i) the parties belong to a group of corporations under common control or are members of an affiliated service group; (ii) the transaction includes an agreement designed to relieve the fiduciary from any responsibility to the plan or IRA; (iii) the fiduciary is under substantial control and close supervision by a common parent of the parties; or (iv) a fiduciary receives compensation in violation of ERISA's self-dealing prohibited transaction rules. Q&A 28.

Fiduciary Can be Considered Independent Even if it Receives Third Party Compensation. In applying these concepts to the question of whether a plan fiduciary could be considered independent if it receives indirect compensation in the form of revenue sharing or 12b-1 fees, the FAQs concludes that the plan fiduciary could be considered independent if (i) the fiduciary had no common ownership or control affiliation with other parties involved in the transaction; (ii) the fiduciary meets the requirements of the BIC Exemption (presumably to exempt any self-dealing prohibited transaction issues); and (iii) there is no agreement or understanding between

the fiduciary and other parties involved in the transaction that would limit the fiduciary's ability to carry out its fiduciary duty to the plan. Q&A 28.

Although the FAQs do not mention this, it would also seem possible to establish the independence of a fiduciary without meeting the requirements of the BIC exemption in (ii) above by ensuring that any third-party payments or revenue sharing payments to the fiduciary were subject to an off-set, as discussed in connection with the discussion above regarding DOL Advisory Opinion 97-15A; see discussion of Q&A 7 above.

Retirement Adviser Cannot Receive any Direct Fees from Plan or IRA. Another issue addressed by the FAQs with regard to the independent fiduciary exception is the requirement that the retirement adviser not receive any fee or other compensation directly from the plan, plan fiduciary, plan participant, or beneficiary, IRA, or IRA owner. The FAQs address an example where the retirement adviser recommends to the plan's independent fiduciary that it use the retirement adviser's model portfolio services and then charges the independent fiduciary a fee for investment advice. The question is whether the fee paid by the independent fiduciary to the retirement advisor is a direct fee for investment advice that would invalidate the use of the independent fiduciary exception. The FAQs helpfully respond that the DOL would not treat the payment between financial intermediaries (i.e., the fee paid by the independent fiduciary to the retirement adviser) as a direct fee for investment advice for purposes of the independent fiduciary exception as long as the fee is not paid with plan or IRA assets, and the plan or IRA does not reimburse the independent fiduciary for its payment of those fees. Q&A 29.

(e) How Does the Platform Exception Apply?

In general, under the Regulation, a person can avoid characterization as an investment fiduciary if it provides a platform or similar mechanism from which an independent fiduciary for the plan selects or monitors plan investment alternatives for an individual account plan; provided that the person markets the platform without regard to the individualized needs of the plan. In addition, a person who identifies investment alternatives for such a platform based on objective criteria specified by the plan's independent fiduciary is also saved from characterization as an investment advice fiduciary, as long as certain disclosure requirements are met.

Group Annuity Contract Can Qualify as a Platform. The FAQs clarify that a platform for this purpose can consist of a group annuity contract issued by an insurance company that provides a range of investment alternatives. Q&A 30. The FAQs also clarify that such an annuity contract would still be considered a platform if the only capital preservation asset class on the platform were the insurance company's own proprietary fixed income separate account. The broader principle of the FAQs is that (i) inclusion of proprietary investment options is consistent with the requirements of the platform exception, and (ii) the existence of only one investment option in certain asset classes does not make the platform exception unavailable. Q&A 31.

Record-Keepers Can Rely on Platform Exception. The FAQs provide that a record-keeper for a plan can rely on the platform exception with respect to a platform that it makes available to plans and for which it provides record-keeping services. Q&A 32.

The FAQs contain an example in which a plan representative requests a record-keeper to provide a list of investment alternatives available on its platform that would meet the plan's investment policy. In the example, the investment policy specifies the asset classes, investment strategy, expense ratio range, risk and return characteristics, and type of investment vehicle for investment alternatives that may be included in the plan. The FAQs provide that the record-keeper could rely on the platform exception in such an instance if it provided a list of all of the investment alternatives available on the platform that meet the requirements of the plan's investment policy statement. To the extent the record-keeper exercises discretion in narrowing the list of investment alternatives, the record-keeper could be treated as providing an investment recommendation if a reasonable person would view the communication as a recommendation that the fiduciary choose investments from the selective menu screened by the record-keeper. Q&A 33.

The FAQs provide that the platform exception is available to a record-keeper who includes record-keeping and other services as part of the record-keeper's platform of investment alternatives, such as access to one or more investment managers to assist a plan sponsor or participant in choosing investment alternatives. The FAQs state that merely connecting plans with investment management firms as an elective option would not necessarily constitute a recommendation that the plan sponsor or participant use the investment management firm for investment advice, depending on the content, context, and presentation of the available services. Q&A 35.

Conclusion

The FAQs provide helpful guidance on a number of issues relating to exceptions to the application of the Regulation. There are still unanswered questions, but more significant in the short run will be the practical effect of the presidential election and whether the Regulation will survive Congress and the incoming administration.

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Client Alert

October 31, 2016

DOL Issues First Guidance on Fiduciary Rule

By Hillel Cohn and Paul Borden

On October 27, 2016, the U.S. Department of Labor ("DOL") issued initial guidance on its new fiduciary rules, which are scheduled to become effective on April 10, 2017. The guidance was issued in the form of FAQs and is expected to be the first of three rounds of guidance to be published by DOL prior to the effective dates of the new rules.[1]

Perhaps not surprisingly, the FAQs address in large part a variety of compensation questions that are top of mind for both broker-dealer firms and their financial advisers.

BACKGROUND

In April 2016, the DOL greatly expanded the scope of persons who would be deemed fiduciaries under ERISA[2] and Internal Revenue Code (the "Code") when dealing with retirement plans and IRAs. As revised, any broker-dealer or financial intermediary ("Financial Institution") that makes any suggestions as to how or where a retirement investor should invest may be a fiduciary. In addition, the individual financial advisers or registered representatives employed by Financial Institutions ("FAs") may be fiduciaries. Given the prohibitions under ERISA and the Code regarding self-dealing by fiduciaries, the expanded definition effectively proscribes the use of commissions and other variable compensation in dealings with retail retirement investors unless the transaction can fit into an available exemption. Of particular interest when dealing with retail retirement investors are two new exemptions released by DOL in April 2016: the Best Interest Contract Exemption ("BIC Exemption") and the Principal Transactions Exemption ("Principal Exemption"). Each exemption requires the Financial Institution and FAs to adhere to "Impartial Conduct Standards," and they impose a number of other requirements. The Impartial Conduct Standards require the Financial Institution and the FA to act in the best interest of the retirement investor in order to avoid unreasonable compensation and to make full and fair disclosure of all material facts, including all fees and any material conflicts of interest.

GUIDANCE FROM THE FAQS

The FAQs address a number of important topics as summarized below.

Scope of BIC Exemption

The FAQs confirm that the BIC Exemption is potentially available for transactions in all categories of assets.

[1] https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/coi-rules-and-exemptions-part-1.pdf
[2] The Employee Retirement Income Security Act of 1974, as amended.

What Constitutes Unreasonable Compensation?

Both the BIC Exemption and the Principal Exemption prohibit the receipt of compensation "that is in excess of reasonable compensation…" The FAQs advise that "the essential question is whether the charges are reasonable in relation to what the investor stands to receive for his or her money." DOL suggests that, to avoid the receipt of unreasonable compensation, Financial Institutions should be attentive to market prices and benchmarks; prudently evaluate the retirement investor's needs; make sure they make full disclosure of all charges, costs and conflicts of interest; and stay alert to potential abusive practices involving customer fees and charges.

Incentive Compensation for FAs

DOL advised that Financial Institutions may continue to use incentive compensation for their FAs and still comply with the BIC Exemption. However, DOL strongly cautioned that any such arrangements must be carefully structured and monitored to avoid creating, or allowing the continuation of, incentives for FAs to act in a manner that would not be in the best interest of the retirement investors.

DOL advised that it would be improper to base incentives to FAs on the relative profitability to the Financial Institution of certain products. For example, a Financial Institution should not pay an FA a higher commission for selling Fund A as compared to Fund B if the funds are similar products but Fund A has a higher payout to the Financial Institution. Rather, incentives should be based upon "neutral" factors, such as the amount of work involved or other factors justifying distinctions in the amount of compensation payable to FAs for certain categories of products.

DOL also cautioned that any volume-based incentive grids should not include provisions that might tempt FAs to act imprudently. For example, increases in payout percentage as the FA progresses up the grid should be "modest," and there should be no retroactive application of higher payout percentages to transactions completed before the FA qualified for the higher payout level.

Recruitment Bonuses

DOL advised that signing bonuses used to hire FAs should be compatible with the new rules, provided that the bonus is not contingent upon any sales or similar production target. Back-end loaded recruitment bonuses that largely depend upon reaching certain production levels are viewed by DOL as creating "acute conflicts of interest that are inconsistent" with the BIC Exemption.

Level Fee Fiduciaries

In the FAQs, DOL acknowledged that a Financial Institution may manage some accounts on a Level Fee Fiduciary basis while managing other accounts on a commission basis.

DOL confirmed that the fees of a Level Fee Fiduciary who is compensated on the basis of a percentage of assets under management or a similar model ("AUM") would not be prohibited transactions under the new rules. As a result, a Level Fee Fiduciary need not comply with the BIC Exemption in order to charge a fee based on AUM. However, Level Fee Fiduciaries are still fiduciaries under the rule, and they need to act in the best interest of their

retirement investors. In this regard, a recommendation to roll over an IRA, or to change a commission-based account to a flat fee account, may entail a conflict of interest for the fiduciary who stands to benefit from a stream of fees generated by the new account. As a result, such recommendations could be prohibited transactions. The BIC Exemption includes a "short-form" provision that enables the Level Fee Fiduciary to comply by acknowledging in writing its fiduciary status, adhering to the Impartial Conduct Standards and documenting the basis for the recommendation to roll over or open a new account.

DOL further advised that a Financial Institution seeking to qualify as a Level Fee Fiduciary may not receive transaction-based payments from third parties in connection with any accounts managed on a level fee basis, nor may it limit its investments to proprietary products. Third-party payments would be viewed as the equivalent of commissions and would require the Financial Institution to comply with all provisions of the BIC Exemption. Similarly, the conflicts associated with proprietary product are viewed by the DOL as inconsistent with the status of a Level Fee Fiduciary if its compensation is in any manner contingent upon recommending proprietary products.

Bank Networking Arrangements

The new rules permit a bank to receive payments from an unaffiliated broker-dealer with whom it has a networking arrangement, provided that the bank complies with the Impartial Conduct Standards. In the FAQs, DOL advised that a referral by a bank to an affiliated broker-dealer would not, in and of itself, be viewed as investment advice, but rather would be viewed as marketing the services of an affiliate, which would not trigger fiduciary concerns.

Effective Date

As expected, DOL advised that it does not intend to delay the effective date of the new requirements. The new rules will become effective on April 10, 2017, although compliance with some of the new contract provisions is deferred to January 1, 2018. DOL indicated that it will continue to work with the industry during the initial compliance period, with a view to assisting rather than sanctioning those who are making a good faith effort to comply. In light of the significant penalties that can arise from violations of these complex new requirements, the financial industry will certainly welcome a cooperative approach from DOL.

CONCLUSION

The FAQs provide helpful guidance on a number of issues. In particular, they illuminate two important aspects of the new rules: (i) the implications of compensation arrangements for FAs and (ii) compliance requirements for level fee fiduciaries.

DOL has consistently emphasized that Financial Institutions seeking to comply with the BIC Exemption or the Principal Exemption must not utilize compensation arrangements for FAs that might encourage them to make recommendations that are not in the best interest of the retirement investor. With their extensive comments on compensation grids, the FAQs serve notice that DOL will scrutinize the details of compensation arrangements to enforce this requirement. The FAQs indicate that compensation incentives that "incentivize the adviser to recommend investments based on their profitability to the firm, rather than their value to the investor" will not be

acceptable. Traditional incentive programs based on contributions to firm profitability will need to be re-evaluated. The FAQs also reiterate that Financial Institutions have an on-going obligation to carefully monitor how compensation arrangements are affecting FA behavior.

The FAQs remind level fee fiduciaries, such as investment advisers and broker-dealers managing accounts on a fee-basis, that they are not exempt from the new rules. Although fees based on AUM are not variable compensation requiring compliance with the BIC Exemption, recommendations to roll over a retirement account or to change an account from commission-based to fee-based do require compliance with a streamlined version of the BIC Exemption. Moreover, receipt of third-party payments or limitation of recommendations to proprietary products would vitiate reliance on the provisions for level fee fiduciaries and would require them to comply with all of the relevant provisions of the BIC Exemption. Finally, like all fiduciaries, level fee fiduciaries are subject to the Impartial Conduct Standards.

The FAQs do not address most of the questions raised by investment bankers and product sponsors regarding underwriting and distribution arrangements for many investment products. Hopefully, the succeeding FAQs will address these issues.

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Morrison & Foerster News Bulletin Volume 8, Issue 4 May 1, 2017

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

FINRA's Proposed Amendments to the Corporate Financing Rules – Impact on Structured Notes

In April 2017, FINRA released a set of significant proposed amendments to its Rule 5110, known as the "Corporate Financing Rule." FINRA's regulatory notice relating to the proposed amendments, together with the text of the proposed revisions, may be found here.

The proposed revisions would make substantive, organizational and terminology changes to the rule. According to FINRA, the proposal is intended to modernize the rule, and to simplify and clarify its provisions.

In this article, we discuss the potential impact of the proposed revisions to the rule on offerings of structured notes. For additional discussion of the proposal, please see our client alert, which may be found here.

Underwriting Compensation and Hedging Activities

The proposal includes an effort to consolidate the existing provisions of the rule into a single definition of "underwriting compensation" to mean "any payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering."

In many structured note offerings, the underwriter or its affiliate will enter into a hedging transaction with the issuer. Accordingly, these arrangements raise the question of whether that hedge transaction could be deemed "underwriting compensation," requiring disclosure of the transaction's value.

The proposed rules take a similar approach to the existing rules. New "Supplementary Material" would provide, in part: "derivative instruments acquired in a transaction related to the public offering and at a *fair price*, will be considered underwriting compensation but will have *no compensation value*." (Emphasis added.) In contrast, "derivative instruments acquired in a transaction related to the public offering but *not at a fair price*, will be considered underwriting compensation and subject to the normal valuation requirements of this Rule and members must provide a description of the methodology used to value the [derivative instrument]." (Emphasis added.)

The proposal indicates that a derivative will be considered to have been entered into at "fair value" when "participating members have priced a derivative instrument or non-convertible or non-exchangeable debt security in good faith, on an arm's-length, commercially reasonable basis, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions."

Similar to the existing rule, the proposal appears to contemplate hedging arrangements between issuers and their affiliated underwriters, provided that the terms of the transaction satisfy the specified criteria.

The proposed new rules would purport to bar an underwriter from receiving underwriting compensation "for which a value cannot be determined." Of course, a party to a hedge transaction will likely not know the amount of profit or loss that may result from the transaction. However, that fact would not appear to bar entry into the hedge, as long as the transaction itself, like most financial transactions, can be valued.

Disclosure Requirements

The SEC regulation governing prospectus disclosures, Regulation S-K (Item 508), incorporates by reference FINRA's rules, and requires disclosure in the "Plan of Distribution" section of all items considered to be underwriting compensation. The proposed amendments attempt to provide guidance to issuers as to how to satisfy this disclosure obligation.

Under the proposed amendments, the specific value of each item of compensation need not be separately disclosed in the "Plan of Distribution" section. Instead, the proposed rules would provide that this section of the prospectus must simply describe the maximum aggregate amount of all underwriting compensation. As a result, the rule would clarify that, for example, if an underwriter receives an "underwriting discount" and a "structuring fee" (and/or other compensation, such as a license fee) for its services, these items would not need to be separately quantified in the Plan of Distribution section. However, to the extent that the underwriters receive compensation that is additional to the underwriting discount, the underwriting table on the prospectus cover page would need to include a footnote that cross-references the "Plan of Distribution" section in which the additional compensation is described.

Filing Requirements

Most structured notes are offered by financial institutions that have outstanding investment grade debt securities that rank equally with the structured notes. Accordingly, few offerings relating to structured notes are filed with FINRA given the availability of the exemption from FINRA filing that applies to these investment grade debt issuers. As a result, we will not address here the proposed changes to FINRA's filing requirements, such as its lengthening of the period in which offering documents must be filed. However, where offerings are required to be filed, if the underwriter or an affiliate enters into a derivative transaction relating to the public offering, the instrument will be subject to the filing requirement, and must be accompanied by a representation that a registered principal or senior manager of the participating member has determined if the transaction was or will be entered into at a fair price.

Exempted Offerings

The proposed amendment makes explicit that Rule 144A and Regulation S offerings of securities are exempt from the Corporate Financing Rule. This has become understood in the market, but was not explicitly stated in the text of the existing rule. Regulation D Rule 506 offerings were specifically exempt from the rule, and that would continue to be the case under the proposal.

Comment Period

FINRA has established a comment period ending May 30, 2017 for interested persons to submit comments.

Massachusetts Secretary of State Challenges Sales of Structured CDs and Other Complex Products

A March 2017 consent order between the Massachusetts Securities Division and a broker-dealer serves as a useful reminder of sales practices that are best avoided in sales of complex instruments, whether in Massachusetts or any other state. The order focuses in particular on how improper incentives provided to registered representatives can lead to improper or unsuitable sales.

The Broker and Its Products

In the case at issue, a broker based in another state had partnered with local community banks, including several in the state of Massachusetts, to offer bank customers a variety of investment products. The broker occupied space within these community banks to offer products, and would share a portion of its revenues with the relevant banks. Among the products offered were market-linked certificates of deposit, non-traded REITs, non-traded business development companies and variable annuities. All of these products have been scrutinized in the past by FINRA and other regulators due to their potential complexity or potential risks.

Supervisory Procedures and Incentive Sales

The broker maintained supervisory procedures that limited its ability to award sales for particular financial products, that would serve as a "luxury" for the relevant persons or that would reward their spouses or other family members. Under the supervisory procedures, trips and other similar activities were chiefly designed to consist of training for the relevant representatives. Trips and similar activities required approval from the chief compliance officer. The procedures, citing relevant FINRA notices, also stated that the broker would not engage in sales contests that favored any one particular product or type of product over others.

However, in reality, the broker did, in fact, award vacations as a prize to its top ranking financial consultants. The broker also awarded accommodations to a guest of winners at its training sessions in the Caribbean. An official of the broker-dealer suggested to regional directors that they should use an upcoming contest to motivate sales. The broker also awarded baseball tickets, together with dinner and drinks, as a tool to spur additional sales. These prize programs were approved by executive officers of the broker. Needless to say, the consent order suggests that these prizes were believed to have incentivized representatives to sell the relevant products.

Sales to Vulnerable Investors

Financial representatives that received prizes under these programs made sales of a variety of complex instruments, including market-linked certificates of deposit, to elderly investors. In one case, the market-linked CD was purchased with the proceeds of a traditional non-market-linked CD. The Massachusetts secretary of state alleged that an elderly investor did not understand all of the risks of the market-linked CD, including that it would need to be held to maturity to guarantee a return of principal.

Violation of Law and Takeaways

As a result of these circumstances, the state of Massachusetts alleged that the broker did not properly supervise its representatives.

The case is a reminder that written supervisory procedures are only truly useful if followed. Sales incentives can compromise the judgment of registered representatives, and result in inappropriate recommendations. Broker-dealer compliance professionals are encouraged to exercise caution when approving them, and to consider whether and how they might steer investors to unsuitable investments.

FINRA Observes Second Anniversary of Its Senior Helpline

On April 21, 2017, FINRA issued a press release marking the second anniversary of its Securities Helpline for Seniors. The press release may be found here.

As most of our readers know, the Helpline provides a toll-free number that senior individuals and their caretakers can call to voice concerns about the handling of their brokerage and investment accounts. The Helpline has not only been a useful resource for these individuals, but it has also helped FINRA understand the types of issues that these investors face.

The release notes a number of interesting statistics relating to the use of the Helpline in its two-year history:

Total calls to the Helpline:	9,200
Number of states from which calls were placed:	50
Average age of callers:	70
Number of matters referred to federal, state and non-U.S. regulators:	65
Referrals to adult protective services:	130
Voluntary reimbursements to callers generated through the Helpline:	$4.3 million

FINRA notes that the calls raised concerns about, among other issues, potential unsuitable recommendations, account churning, fraud and illegal activity involving brokerage accounts and investments.

FINRA also notes, approvingly, that many FINRA member firms have established designated points of contact to work with Helpline staff to streamline the resolution of investor issues.

In the release, FINRA also reported that in one case a senior investor called regarding an investment in a structured CD. The investor stated that the terms of the CD were not consistent with what he understood at the time of the purchase, and he indicated that, prior to the investment, he received 1% per year on a (conventional) savings account. At the time of purchase, and his move away from the conventional account, he was told the CD would pay 2.5 to 3.5% per year; however, when he received the confirmation of his purchase, he noticed that the return would be spread over the six-year term of the product. After speaking to FINRA's Helpline staff, the relevant broker-dealer agreed to sell the CD for the investor and to reimburse the customer for any loss incurred on the sale. This fact pattern reminds us that even relatively simple structured products, such as "lightly structured" CDs, have the potential to be mis-sold, and the sales of such products often require substantial supervision and training.

FINRA Revises Its Sanction Guidelines

In April 2017, FINRA announced that it had revised its sanction guidelines for violations of its rules. The new revisions, among other things:

- contain a new factor requiring that the exercise of undue influence over a customer, such as an elderly investor, be considered when adjudicating violations;
- introduce three new sanction guidelines: "Systemic Supervisory Failures," "Short Interest Reporting," and "Borrowing From or Lending to Customers";

- create a new factor related to the mitigating effect of regulator or firm-imposed sanctions and corrective actions that have been taken; and
- amend a number of sections of the sanction guidelines to revise sanctions for more serious FINRA rule.

The revised sanction guidelines became effective immediately, and may be found on FINRA's website here.

By way of explanation, the sanction guidelines do not stipulate fixed punishments or penalties for violations of the FINRA rules. Instead, the premise of the sanction guidelines is that FINRA adjudicators have a range of potential sanctions for a particular violation, and they may consider aggravating and mitigating factors in order to arrive at an appropriate sanction for the relevant violation.

The new revisions are the result of FINRA's most recent review of the sanction guidelines. FINRA has indicated that additional review is currently in process as to potential additional changes.

Our Take and a Few Additional Points

The new guidelines address a number of issues that have recently been of significant interest to U.S. regulators. For example, consistent with recent regulatory attention, FINRA has introduced a new principal consideration that examines whether a broker-dealer's employee has exercised undue influence over a customer. This new consideration reaffirms the notion that financial exploitation of senior and other vulnerable customers should result in more severe sanctions. This focus on vulnerable investors is consistent with the concerns behind FINRA's recent rule changes relating to senior investors, which we discussed here.

As to short interest reporting, under the prior guidelines, violations involving short interest reporting would have been determined under the guideline related to short sale However, FINRA believed that this method of review did not account for the different factors typically presented by short interest reporting violations. Accordingly, the introduction of the guideline for short interest reporting sets forth considerations that relate specifically to these cases.

FINRA also implemented changes relating to rule violations that involve churning or unauthorized transactions. The low end of the suspension range for an individual respondent who engages in churning or unauthorized transactions increased from 10 business days to one month. The high end of the suspension range for churning and unauthorized transactions for an individual respondent has increased from one year to two years; in addition, the revised guidelines for churning or unauthorized transactions recommend that FINRA adjudicators strongly consider imposing a bar from the industry on an individual respondent when the respondent acted recklessly or intentionally. This change reflects FINRA's 2017 exam priorities letter and its emphasis on excessive trading.

Upcoming Events

A "How to Guide" to Basic Derivatives, Swaps Clearing & Structured Products
New York City Bar
Wednesday, May 3, 2017
Morrison & Foerster Speaking Engagement, 9:00 a.m. – 1:00 p.m. EDT

New York City Bar
42 West 44th Street
New York, NY 10036

This course will enable both in-house and outside counsel to expand their skills and be more valuable to their clients by covering the why, what, when, where and how of derivatives. Partner Anna Pinedo will speak on a panel entitled "Key Considerations in Derivatives and Structured Products and Collateral."

Topics will include: Regulatory margin requirements; collateral posting and protection issues; bankruptcy and credit downgrade considerations; understanding netting of exposures, risk exposure, valuation and risk: notional values,

counterparty risk, pricing and leverage; use of derivatives in M&A; and tax implications of various derivatives and structured notes.

For more information, or to register, please click here.

Unit Investment Trusts and Structured UITs
Thursday, May 4, 2017
Paul Koo and Oscar Loynaz, Alaia Capital & Bradley Berman and Anna Pinedo, Morrison & Foerster LLP
8:30 a.m. – 9:30 a.m. EDT

Morrison & Foerster LLP
250 West 55th Street
New York, NY 10019

A unit investment trust, or UIT, is a type of registered investment company under the Investment Company Act of 1940, in which a portfolio of stocks, bonds or other securities are professionally selected and deposited into the trust. The portfolio is fixed and unmanaged. A UIT can offer investors diversification, liquidity and access to specific investment strategies. A UIT also may offer investors access to more structured returns that, in certain respects, may resemble the returns often associated with market-linked or structured products.

During the session, the speakers will discuss: Basic organizational structure and participants; regulation of UITs; filing and other requirements applicable to UITs; Structured UITs; benefits associated with Structured UITs; UITs and the DOL's fiduciary duty rule; and fiduciary and advisory issues generally.

For more information, or to register, please click here.

Join Our *Structured Thoughts* LinkedIn Group

Morrison & Foerster has created a LinkedIn group, *StructuredThoughts.* The group serves as a central resource for all things *Structured Thoughts*. We have posted back issues of the newsletter and, from time to time, will disseminate news updates through the group.

To join our LinkedIn group, please click here and request to join, or simply email Carlos Juarez at cjuarez@mofo.com.

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For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

Morrison & Foerster is currently nominated for Americas Law Firm of the Year – Overall; US Law Firm of the Year – Transactions and US Law Firm of the Year – Regulatory for *GlobalCapital's* 2017 Americas Derivatives Awards. We were named Americas Law Firm of the Year in 2015 and 2016 by *GlobalCapital* for its Americas Derivatives Awards.

Morrison & Foerster was named 2016 Global Law Firm of the Year by *GlobalCapital* for its Global Derivatives Awards.

Morrison & Foerster was named the 2016 Equity Derivatives Law Firm of the Year at the *EQDerivatives* Global Equity & Volatility Derivatives Awards.

Morrison & Foerster has been named Structured Products Firm of the Year, Americas by *Structured Products* magazine seven times in the last 11 years.

Morrison & Foerster was named Best Law Firm in the Americas four out of the last five years by *StructuredRetailProducts.com*.

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, and Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer*'s A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.