Bridging the Gap – Opportunities in Class B Share Financing

Introduction

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Bridging the Gap – Opportunities in Class B Share Financing

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Class B Shares: Characteristics and Challenges

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Three Classes of Fund Shares

- **Class A**
- **Class B**
- **Class C**

Each presents a different arrangement for paying commissions for share sales

Class B Shares

- **Time gap between distributor's payment of selling commissions at time of sale and later reimbursement for such commissions**
- **Distributor must have or raise money to cover time gap**

Class B Shares *(continued)*

- **No sales charge paid by shareholders at time of sale**
- **Distributor over time receives annual 12b-1 fees paid from fund assets**
- **12b-1 fees reduce shareholders' annual return on investment**

Class B Shares *(continued)*

- **12b-1 fees reimburse distributor for payment of commissions at time of sale plus interest**
- **Class B shares typically convert to Class A shares over time**
- **Reimbursement of distributor stops upon conversion to Class A shares**

Contingent Deferred Sales Charge “CDSC”

- **CDSC paid by shareholder when Class B shares redeemed early**
- **Amount of CDSC approximates amount of commission paid at time of sale**

“CDSC” *(continued)*

Year of Redemption After Purchase	Contingent Deferred Sales Charge	
	Longer Term Funds	Short Term Funds
First	5%	4%
Second	4%	3%
Third	3%	2%
Fourth	3%	1%
Fifth	2%	0
Sixth	1%	0
Seventh and following	0	0

Schedule of CDSCs with reduction over set time periods

Class C Shares

- **Shorter CDSC period**
- **No automatic conversion to Class A shares**
- **Annual 12b-1 fees**
  - **Same annual rate as Class B Shares**
  - **Paid indefinitely**

Two Sources of Reimbursement for Selling Commissions

- **Ongoing 12b-1 fees paid by fund from Class B assets**
- **CDSCs paid by shareholders for early redemption**
  - **These reimbursements over time are receivables**
  - **Distributor may use receivables as collateral for loan or may sell receivables**

Three Sources of Contractual Obligations to Pay 12b-1 Fees and CDSCs

1. **Prospectus and Statement of Additional Information (“SAI”)**

2. **Rule 12b-1 Distribution Plan**

3. **Distribution Agreement**

Sources of Contractual Obligations *(continued)*

1. **Prospectus and Statement of Additional Information ("SAI")**
    - **Investment contract between fund and shareholders**
    - **Establishes features of 12b-1 fees and CDSCs**

Sources of Contractual Obligations *(continued)*

2. Rule 12b-1 Distribution Plan

- **Adopted for each class of shares**
- **Described in prospectus and SAI**

Sources of Contractual Obligations *(continued)*

3. Distribution Agreement

- **Distributor marketing services**
- **Distributor pays selling agents commissions and fees**
- **Fund pays 12b-1 fees and collects CDSCs from shareholders**

Alternatives to Financing

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Three Basic Alternatives to Financing

- **Internally generated cash flow**
- **Borrowing**
- **Sale by distributor of right to receive future CDSCs and 12b-1 payments**

ALTERNATIVE #1

Internally Generated Cash Flow

- **Lower transaction costs and fees**
- **Requires substantial internal cash resources**
- **Tax and accounting considerations**

ALTERNATIVE #2

Secured Loan – with a “Twist”

- **Loan agreement with one or more financial institutions**
- **Requires representations and warranties; covenants and undertakings**
- **“Secured Transaction” under Article 9**
- **Primary collateral: rights to CDSCs and 12b-1 fees**

Secured Loan – with a "Twist" *(continued)*

- **Lenders request "back-up comfort" for early termination**
- **Loan usually for percentage only of anticipated cash flow**
- **Distributor should be prepared to fund balance through cash flow or other loan arrangement**
- **Other arrangements may induce 1st lender to finance more**

ALTERNATIVE #3

“True Sale” Transaction

- **Distributor sells and conveys rights to receive future CDSC and 12b-1 payments**

Regulatory Issues in “Sale” Transactions

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Common Risks

- **Rule 12b-1 Termination Risk**
- **CDSC Termination Risk**
- **Regulatory Risk**
- **Net Asset Value Risk**

Rule 12b-1 Termination Risk

- **Board may terminate 12b-1 plan or Fund may fail to comply with Rule 12b-1**
- **Director/Trustee fiduciary duties in approving and continuing 12b-1 plans**

Rule 12b-1 Termination Risk *(continued)*

- **Fiduciary duties may not be contracted away**
- **Purchaser typically negotiates payments only to purchaser if termination of 12b-1 plan**

Rule 12b-1 Termination Risk *(continued)*

- **Purchaser attempts to require distributor to recommend plan continuation to Board**
- **Conflicts of interest issues**

CDSC Termination Risk

- **Board may terminate or reduce CDSC payments**
- **Payments are fund shareholder obligations**
- **Rule 22d-1 and Rule 6c-10 require full disclosure to shareholders**

CDSC Termination Risk
(*continued)*

- **CDSC terms may be negotiated under distribution agreement and become obligations of fund**
- **CDSC termination risk not as great**

Regulatory Risk

- **SEC may alter or terminate Rule 12b-1**
- **Congress and SEC currently considering changing Rule 12b-1**
- **Parties to agreements allocate risk among parties**

Net Asset Value ("NAV") Risk

- **NAV might be reduced by adverse events**
  - **Economic conditions**
  - **Poor fund management**
- **NAV reduction reduces 12b-1 fees and CDSC payments**

NAV Risk *(continued)*

- **NAV risk assumed by purchaser of receivables**
- **Purchaser may develop hedging strategies to reduce risk**

Compliance Monitoring

- **Valid creation of 12b-1 fees and CDSC receivables essential**
- **Must continuously monitor requirements and obligations of Credit Agreement or Sale of Receivables Agreement**

Compliance Monitoring *(continued)*

1. **12b-1 Plans and payments**

2. **Proper disclosure of CDSCs in prospectus and SAI**

Compliance Monitoring *(continued)*

3. **Free exchanges and free redemptions of class shares**

4. **Investment objectives, policies and limitations**

Compliance Monitoring *(continued)*

5. **Addition or deletion of new funds or share classes**

6. **Receivable payment tracking systems**

Alternative #3 - Sale of 12b-1 Fees and CDSC Receivables

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“Sale” Alternative

- **Ready source of funds without repayment obligation**
- **Potential tax and accounting advantages**
- **Removes NAV volatility from distributor’s risk calculation**

“Sale” Alternative *(continued)*

- **Outright transfer to 3rd party of distributor’s rights to receive CDSCs and 12b-1 fees**
- **Continuous cash flow rights transfer – sales often daily or weekly**
- **May take buyer time to accumulate substantial value**

Buyer's Use of Cash Flow Rights

- **May hold until liquidation at more than purchase price**
- **May accumulate unliquidated cash flow rights and sell to 3rd party in "securitization"**

"True Sale" Characteristics

- **Object – to vest ownership of cash flow rights in buyer to withstand bankruptcy or insolvency of distributor**
- **Buyer becomes creditor of distributor for monies advanced if bankruptcy court invalidates sale**

Ensuring "True Sale" Status

- **Language in purchase and sale agreement must address:**

  1. **Potential legal challenges**
  2. **Intent of parties to characterize transfer as "sale"**
  3. **Article 9 issues**

Purchase and Sale Agreement

4. **Identity of funds selling B Shares**

5. **Purchase price**

6. **Conversion and exchange issues**

Purchase and Sale Agreement *(continued)*

7. **Exclusion of certain shareholders as "eligible accounts"**

8. **Flexibility to allow other funds to join as "Additional Eligible Funds"**

Purchase and Sale Agreement *(continued)*

9. **Clear direction regarding transmission of cash stream to avoid co-mingling with seller's funds**

10. **Length of program and termination**

Other Considerations

- **Regulatory issues**
- **Due diligence**
- **Prospectus disclosure for funds**

Other Considerations

(continued)

- **Effect of distributor’s choice to elect a separate entity to buy CDSCs and 12b-1 cash flows at end of term**
- **Allocation issues**

Federal Tax Considerations in 12b-1 Securitizations

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Characterization of 12b-1 Fee Securitizations

- **Similar to securitization of financial assets generally**
- **Rights to 12b-1 receipts pooled for economies of scale**
- **Interests may be sold to investors by sponsor/distributor**

Characterization of 12b-1 Fee Securitizations *(continued)*

- **Investors paid from receipts generated by asset pools**
- **Investor interests supported by 3rd party guarantees or over-collateralization**

Characterization of 12b-1 Fee Securitizations *(continued)*

- **Sponsor/distributor typically remains as servicer or guarantor**

- **Sponsor/distributor holds residual interest**

Rational for Securitization

- **Risk Shifting**
- **Transferring debt off distributor/ sponsor's balance sheet**
- **Regulatory compliance**

Which Special Purpose Entity?

- **Corporation**
- **Partnership**
- **Trust**
- **Business Trust**
- **Financial Asset Securitization Investment Trust ("FASIT")**

Which Special Purpose Entity? *(continued)*

"FASIT"

- **Risky for use in securitizing 12b-1 fees**

  1. **Receivables may not be "debt"**
  2. **"FASIT" provisions may be repealed**

Which Special Purpose Entity? *(continued)*

Corporations

- **Used historically**
- **Earnings subject to "double taxation"**

Which Special Purpose Entity? *(continued)*

Common Law Trust

- **One level of tax**
- **Restrictions on use imposed by Treasury Regulations**

Which Special Purpose Entity? *(continued)*

Business Trust

- **Taxed as either corporation OR partnership**
- **May elect tax treatment**

Which Special Purpose Entity? *(continued)*

Business Trusts - continued

- **“Publicly Traded Partnership” may be taxed as corporation**
- **12b-1 receivable may fail to qualify as “passive income”**

Interests – Debt or Equity?

- **If “equity”:**
  1. **Potential registration of entity as “investment company” under 1940 Act**
  2. **Burdensome regulatory requirements**
  3. **Distributions to individual investors are “dividend income” taxed at ordinary income rates**
  4. **Distributions to foreign investors may be liable for withholding tax**

Interests – Debt or Equity?

(continued)

- **If “Debt”:**

  1. **Interest received by investor is taxed as “ordinary income”**
  2. **Foreign investor may be eligible for withholding tax exemption**

Jobs and Growth Tax Relief Reconciliation Act of 2003

- **“Qualified dividends” distributed to individuals taxed at lower long-term capital gains rates**
- **“Qualified dividends” are those distributed by U.S. or “qualified” foreign corporation**

Debt/Equity Distinction Important to Issuer

- **Special purpose entity**
  1. **May NOT deduct dividends**
  2. **May deduct interest**
- **Preferable to characterize as “debt”**
- **“9 - 16 factor test”**

Business Trust – Preferred Vehicle

- **May elect taxation as partnership**
- **May issue both debt and equity**

Recent Pronouncements by Financial Accounting Standards Board

- **Generally represent GAAP**
- **Interpretation Number 46 – Post-Enron**
    1. **Revises accounting rules regarding consolidation of entity with sponsor**
    2. **Applies to securitization entities created after January 31, 2003**

Interpretation Number 46

(continued)

- **New designation of entity as “variable interest entity” (“VIE”)**
- **Qualifies as “VIE” with “primary beneficiary” if two conditions apply**

Interpretation Number 46
(continued)

(VIE conditions – continued)

- **Total equity investment insufficient to finance without other support**

AND

- **Holders as a group lack:**
  1. **Ability to influence entity through voting rights; OR**
  2. **Obligation to absorb entity's losses; OR**
  3. **Right to receive entity's residual returns**

Interpretation Number 46

(continued)

- **Definition of “Primary Beneficiary”**
- **Enterprise that holds variable interests that absorb majority of entity’s expected losses or receive majority of expected residual returns**

Interpretation Number 46

(continued)

- **Entity will need additional financial support if equity investment is less than 10%**

Thank you for joining us for

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