Bridging the Gap – Opportunities in Class B Share Financing

Introduction

Kevin P. Kundra, Esquire
Partner, Business Law Department
Chair, Structured Finance Practice Group
Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103
www.stradley.com

215-564-8183
kkundra@stradley.com
Bridging the Gap – Opportunities in Class B Share Financing

1. Class B Shares: Characteristics and Challenges (Merrill R. Steiner)

2. Alternatives to Financing (David R. Landrey)

3. Regulatory Aspects of Sales (Merrill R. Steiner)

4. “True Sale” Issues (David R. Landrey)

5. Tax Treatment (David L. Meyer)
Class B Shares: Characteristics and Challenges

Merrill R. Steiner, Esquire
Partner, Investment Management Group
Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103
www.stradley.com

215-564-8039
msteiner@stradley.com
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)

<table>
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<th>Year of Redemption After Purchase</th>
<th>Contingent Deferred Sales Charge</th>
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<td>Longer Term Funds</td>
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<tr>
<td>First</td>
<td>5%</td>
</tr>
<tr>
<td>Second</td>
<td>4%</td>
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<tr>
<td>Third</td>
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<td>Fourth</td>
<td>3%</td>
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<tr>
<td>Fifth</td>
<td>2%</td>
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<tr>
<td>Sixth</td>
<td>1%</td>
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<td>Seventh and following</td>
<td>0</td>
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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

David R. Landrey, Esquire
Partner, Business Law Department
Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA  19103
www.stradley.com

215-564-8038
dlandrey@stradley.com
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

Merrill R. Steiner, Esquire
Partner, Investment Management Group
Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA  19103
www.stradley.com

215-564-8039
msteiner@stradley.com
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
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

David R. Landrey, Esquire
Partner, Business Law Department
Stradley Ronon Stevens & Young, LLP
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Philadelphia, PA  19103
www.stradley.com

215-564-8038
dlandrey@stradley.com
“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”
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

David L. Meyer, Esquire
Of Counsel, Tax Department
Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103
www.stradley.com

215-564-8099
dmeyer@stradley.com
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”)
“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
• Entity will need additional financial support if equity investment is less than 10%
Thank you for joining us for

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David R. Landrey, Esq. dlandrey@stradley.com
David L. Meyer, Esq. dmeyer@stradley.com

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