

REVERSE inquiries
Workshop Series

Structured UITs and Repack Structures

April 8, 2019

Agenda

- 40 Act vehicles
- Basic repackaging concepts
- Repackaging through a trust on an exempt basis or repackaging in reliance on Reg AB II
- Tax considerations

BASIC TRUST STRUCTURE

Basic structure

- Institutional investor seeks structured product-like exposure and has, on a reverse inquiry basis, identified a basic payout
- Institutional investor may want to diversify issuer concentration
- A structured note equivalent can be issued through a trust, the assets of which will be a plain vanilla bond and a derivative, an option or a warrant

Using a trust

- A trust is a common vehicle for repackaging debt (or other) securities or assets as well as accompanying derivatives or options. However, there are a number of structuring concerns associated with using a trust vehicle.
 - A trust usually is a passive vehicle (neither the trustee nor other parties actively manage the investment).
 - With a trust, often there is a concern that the trust will be an investment company under the Investment Company Act of 1940 (1940 Act).

1940 Act

- Why do market participants often seek to avoid investment company status?
 - If a trust is determined to be an investment company, it must register as such under the 1940 Act.
 - Subject to regulatory scheme of the 1940 Act – reporting and other filing obligations.
 - Limits on ability to transact with affiliates (sponsor/depositor may not be able to engage in business with the trust – for example, an affiliate that “underwrites” offerings of an investment company is subject to restrictions).
 - Restrictions on the issuance of debt.
 - Must satisfy asset coverage test – 300% immediately following issuance of debt and 200% immediately following issuance of preferred securities.

1940 Act *(cont'd)*

- An investment company is defined as an issuer that:
 - Is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities;
 - Is engaged in the business of issuing face-amount certificates of the installment type; or
 - Is engaged in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of its assets.

1940 Act exemptions

- There are a number of exemptions from the 1940 Act.
- Some exemptions require limiting the number of investors:
 - For example, Section 3(c)(1) exempts from the definition of investment company any issuer whose outstanding securities are owned by not more than 100 persons and is not making a public offering.
- Some exemptions limit the scope of the business activities of the vehicle:
 - Section 3(c)(5) exempts from the definition any issuer not engaged in investment company activities but that is engaged in purchasing or acquiring notes, making loans or purchasing or acquiring mortgages, among other activities.

1940 Act exemptions *(cont'd)*

- Other exemptions limit ownership to certain classes of investors.
 - For example, Section 3(c)(7) exempts from the definition of investment company any issuer whose securities are owned by “qualified purchasers” and is not making a public offering.
 - A “qualified purchaser” is:
 - Any person that owns not less than \$5,000,000 in investments;
 - Any company that owns not less than \$5,000,000 in investments and that is owned, directly or indirectly, by or for two or more related natural persons;
 - Any trust not covered by the preceding clause that was not formed for the specific purpose of investing in the securities offered whose trustee and each settlor are qualified purchasers; or
 - Any person acting for its own account or the account of other qualified purchasers, who owns and invests not less than \$25,000,000 in investments.

**REGISTERED INVESTMENT
COMPANY ALTERNATIVE**

Alternative approach

- Instead of choosing an approach that entails an exemption from 1940 Act registration, you may consider a 1940 Act registered vehicle.
- There are several basic types of 1940 Act registered entities: open-end funds (mutual funds) and closed-end funds (or variations of these, like UITs and ETFs).
- These can be sold to retail investors and can be customized.

Unit investment trust

- A type of investment company regulated by the 1940 Act. The unit investment trust (UIT) must:
 - Be organized as a trust;
 - Not have a board of directors;
 - Issue only redeemable securities, each of which represents an undivided interest in a unit of specified securities; and
 - But does not include a voting trust.
- Unit investment trusts (UITs) buy and hold a fixed portfolio of stocks, bonds or other securities – in this case, structured products or bonds and derivative instruments.
 - Portfolio may consist of a wide range of securities.
 - Do not have an investment adviser.

UITs *(cont'd)*

- A UIT makes a one-time public offering of only a specific and fixed number of redeemable securities called “units.”
 - Investors receive a share of the principal and dividends (or interest).
 - Payments can occur monthly, quarterly, semiannually 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 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 the 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 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 organization 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

Who are the parties, and what are their roles? *(cont'd)*

Evaluator:

- Is 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 receives a fixed annual fee for its services
- May be independent from the sponsor/depositor, but does 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

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.

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.

1940 Act considerations

- Under the 1940 Act, a UIT must disclose information in a prospectus about the trust, including:
 - Investment objectives;
 - Portfolio securities;
 - Sales charges and expenses; and
 - Terms for buying and selling units.
- A UIT must file ongoing reports with the SEC under the 1940 Act, including:
 - An annual report containing audited financial statements, management's discussion of fund operations, investments results and strategies.

Issues to consider

- The “buy and hold” strategy of a UIT does not permit substitution of assets in the portfolio
 - If questions arise regarding the issuer’s financial viability or the security’s creditworthiness, it may be possible to sell or replace a security.
- Must register under the 1940 Act
 - 1940 Act issuers may not rely on access equals delivery.
 - No “shelf” form for 1940 Act issuers – issuances on a continuous or delayed basis rely only on SEC no-action guidance.

Issues to consider *(cont'd)*

- 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 directly owned 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.

Tax considerations – regulated investment company

- RIC requirements:
 - Income Test: 90% of gross income must be from “securities” each year
 - Diversification Tests:
 - At least 50% of assets represented by cash, government securities, or “small” ownership positions (no more than 5% of RIC’s assets and no more than 10% of issuer’s voting securities)
 - Not more than 25% of assets invested in securities of any one issuer (or two or more issuers under the RIC’s control, engaged in similar trades or businesses)
 - Distribution Requirement:
 - At least 90% of RIC’s income must be distributed every year; normally 100% is distributed

Tax considerations – regulated investment company

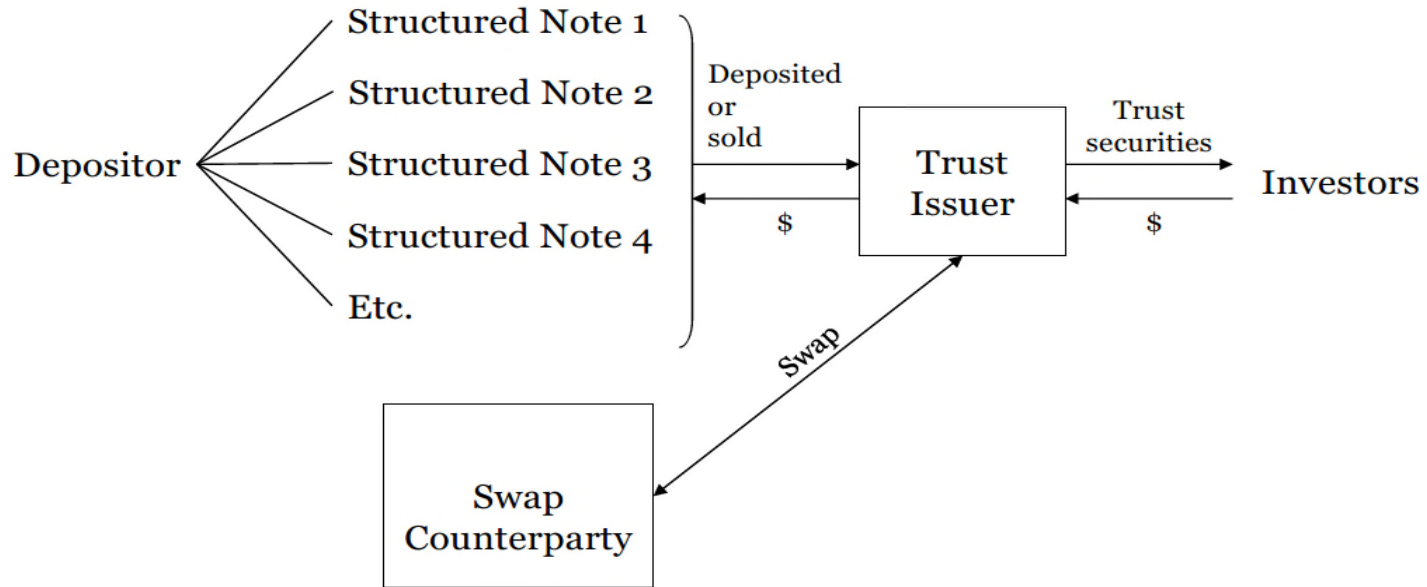
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- RIC requirements:
 - It is a corporation for U.S. federal income tax purposes, but entitled to a dividends-paid deduction (similar to REITs)
 - Holders report RIC dividends as ordinary income
 - Possible to get flow-through treatment on capital gains and dividend income
 - Foreign holders may get withholding exemption for “interest-related dividends,” and “capital gain dividends”

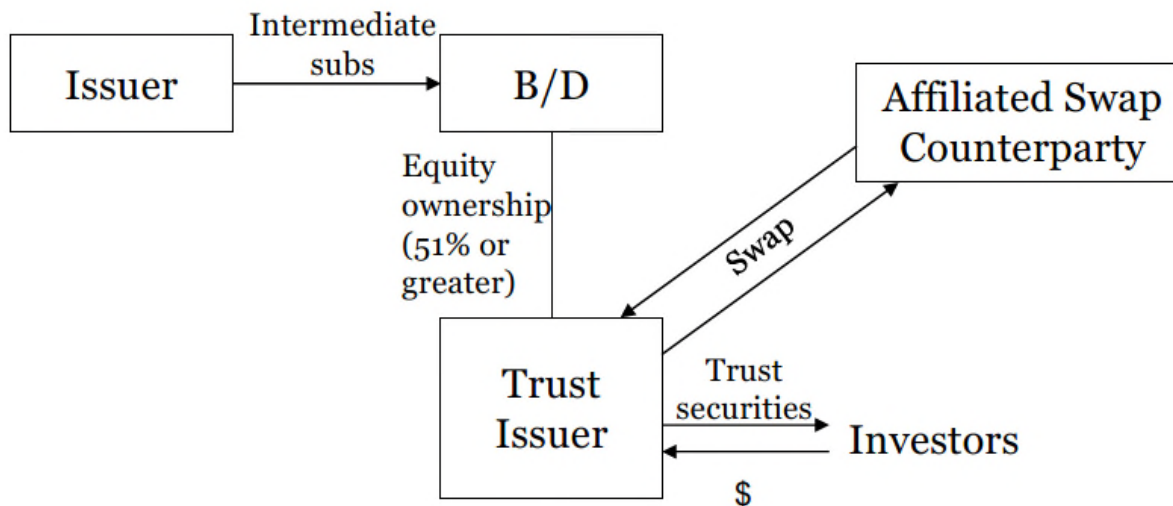
REPACKAGING STRUCTURE AND ANALYSIS

Public alternative

- A trust that sells its securities pursuant to Regulation ABII (similar to a securitization) and is exempt from the 1940 Act.



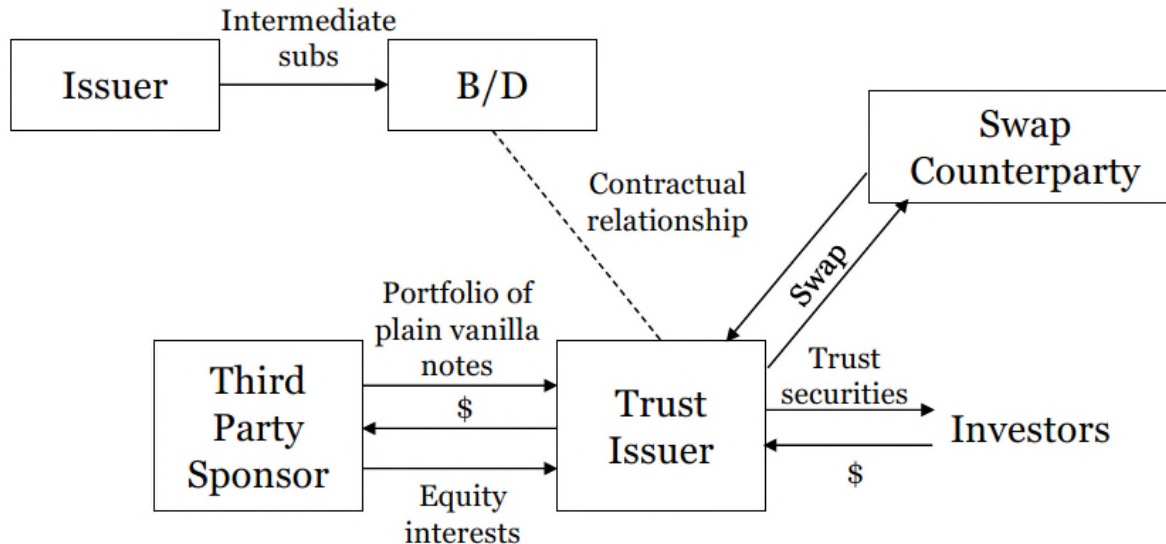
Basic structure



Issues to consider:

- Trust likely will be consolidated for accounting purposes (on balance sheet)
- Accounting for: (1) swap; (2) trust securities; (3) equity interest in trust
- Disclosure/reporting issues

Third-party (Rent-a-Shelf) issuer



Issues to consider:

- Ratings agency analysis: will ratings agencies “look through” or rely on swap counterparty rating?
- However, the only “swaps” or “options” allowed in an SEC-registered vehicle are rate-linked or currency-linked. No equity-linked or credit-linked exposure is possible through the swap or option, which limits the utility of this approach.

Repackagings or resecuritizations

- In a repackaging or resecuritization, assets (usually debt securities) are repackaged in a special purpose vehicle and the special purpose vehicle sells securities.
 - The “repackaging” concept can be applied to any number of underlying assets—for example, a trust, the assets of which are a diverse series of plain vanilla bonds issued by different issuers; a trust the assets of which are a series of CDs; etc.
- Resecuritizations rely on the regulatory scheme established by Regulation ABII (for purposes of this presentation, we will refer to it as “Reg AB”).
- Asset-backed issuers are exempt from the 1940 Act pursuant to Rule 3a-7, which states:
 - Any issuer engaged in the business of purchasing, or otherwise acquiring and holding eligible assets and who does not issue redeemable securities will not be deemed an investment company.

1940 Act considerations for ABS

- Redeemable securities are defined in Section 2(a)(32) as “any security other than short-term paper, under the terms of which the holder upon its presentation to the issuer (or someone designated by the issuer) is entitled to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.”
- Rule 3a-7 contains a number of conditions:
 - The issuer must issue fixed income securities or other securities that entitle their holders to receive payments that depend on the cash flow from eligible assets;
 - Securities sold must be rated investment grade;

1940 Act considerations for ABS *(cont'd)*

- Acquisitions and dispositions of eligible assets may be made only in accordance with governing documents and may not trigger a downgrade in the issuer's rating; and
- Must appoint a non-affiliated trustee that has a perfected security interest in the assets.
- Definition of “eligible assets” is similar to the definition under Reg AB.
 - Financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the distribution of proceeds.
 - “Convert to cash” within a finite time period requirement may pose structuring challenges

Private repackaging vehicles

- Given the limitations of the SEC rules, interests in most repacks are offered on an exempt basis (4(a)(2), Rule 506, Rule 144A, or Reg S)
- For most structures, consideration should be given to:
 - Risk retention and Reg ABII
 - Commodity pool considerations
 - Volcker Rule issues
 - Accounting consolidation and tax treatment

Risk retention

- Most repack vehicles are considered “securitizations” or involve the issuance of asset-backed securities to which the risk retention requirement would be applicable
- Depending upon the facts and circumstances, an analysis may conclude that the repack, or certain series of a repack may not involve the issuance of asset-backed securities, and therefore such series would not be subject to the risk retention requirement

Reg AB background

- Reg AB was amended and became effective in November 2015 to address disclosure differences between issuers of asset-backed securities (ABS) and operating companies. Regulates:
 - 1933 Act registration for these issuers;
 - Disclosure obligations;
 - Communications; and
 - Ongoing 1934 Act reporting obligations.
- Applies to any security that is “asset-backed.”
 - “A security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to ensure the servicing or timing distribution of proceeds to holders. . .”
 - Neither issuer nor depositor may be an investment company.
 - Issuer must passively own or hold the pool of assets.

Reg AB background *(cont'd)*

- Risk retention requirement:
 - For an issuance of asset-backed securities offered pursuant to an exemption such as Rule 144A, a risk retention requirement would apply. The 5% risk retention requirement was adopted as a result of the Dodd-Frank Act.
 - The required retained interest can be satisfied by holding either a “vertical interest” or an “eligible horizontal residual interest” or a combination of the two. A vertical interest would be the same percentage interest in each class of securities issued. An eligible horizontal residual interest would be the most subordinated class or classes representing the required percentage of the “fair value” of all ABS interests to be issued.
 - The retained interest must be held by the “sponsor” or a “majority-owned affiliate.” A “majority-owned affiliate” is defined as an entity in which a person has ownership of more than 50% of the equity or ownership of any other controlling financial interest.

Reg AB background *(cont'd)*

- Risk retention requirement:
 - The rule generally prohibits a sponsor from selling or otherwise transferring any retained interest other than to majority-owned or wholly owned affiliates of the sponsor. Moreover, a sponsor and its affiliates may not hedge their required risk retention positions or pledge those positions as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction), unless the obligation is with full recourse to the pledging entity.
- Certain hedging activities are not prohibited. Sponsors and their affiliates are permitted to:
 - Hedge interest rate or foreign exchange risk, or
 - Hedge based on an index of instruments that includes ABS, subject to certain limitations.

Reg AB background *(cont'd)*

- The retention period for retained interests for all assets other than the residential mortgage loans is the period ending on or after the date that is the latest of
 - The date on which the total unpaid principal balance of the securitized assets that collateralize the securitization are reduced to 33 percent of the original unpaid principal balance as of the closing date,
 - The date on which the total unpaid principal obligations under the ABS interests issued in the securitization are reduced to 33 percent of the original unpaid principal obligations as of the closing date, or
 - Two years after the closing date.

Commodity pool

- Dodd-Frank’s inclusion of swaps and commodity interests means that pooled investment vehicles trading in swaps (and their operators or advisors) must consider whether they may be subject to regulation as a commodity pool, a commodity pool operator or a commodity trading advisor
 - Holding or “trading” a single swap may render an entity a commodity pool
- As amended by Dodd-Frank, the Commodity Exchange Act (“CEA”) now defines the term “commodity pool” broadly to include any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any
 - Commodity for future delivery, security futures product, or swap;
 - Agreement, contract, or transaction described in Section 2(c)(2)(C)(i) of the CEA or Section 2(c)(2)(D)(i) of the CEA;
 - Commodity option authorized under Section 6c of the CEA; or
 - Leverage transaction authorized under Section 23 of the CEA

Commodity pool definition

- In addition, the CFTC, by rule or regulation, may include within, or exclude from, the term “commodity pool” any investment trust, syndicate, or similar form of enterprise if the CFTC determines that the rule or regulation will effectuate the purposes of the CEA
- As a result, an analysis would have to be undertaken to assess whether “swaps” are being used or whether “security-based swaps” may be used instead, or whether interests should be offered solely to non-U.S. persons

Covered fund issues

- Any analysis also would have to include a Volcker Rule analysis
- A banking entity, as principal, may not directly or indirectly acquire or retain an ownership interest in, or sponsor, a covered fund
- A covered fund is defined to include a fund that relies solely on the Section 3(c)(1) or 3(c)(7) exemptions. A fund that can rely on Section 3(c)(1) or 3(c)(7) will not be a covered fund if another 1940 Act exemption is available to it, such as Rule 3a-7
- If the issuer relied on Section 3(c)(1) or 3(c)(7) of the 1940 Act and another 1940 Act exemption is not available, it may still avail itself of one or more of the 14 enumerated exclusions from the definition of covered fund

Exclusions from covered fund definition

- Of these 14 exclusions, four are most likely to be applicable to a securitization issuer:
 - Loan securitization exclusion
 - Qualifying asset-backed commercial paper (ABCP) conduit exclusion
 - Qualifying covered bond exclusion
 - Wholly-owned subsidiary exclusion

Tax considerations – Grantor Trusts

- Grantor Trust Requirements
 - Trust under local law – Delaware statutory trust is typical
 - Single class of equity (for tax purposes)
 - No power to vary the trust's assets (90-day start-up period)
- Grantor Trust Treatment
 - Pure pass-through: Holders treated as owning proportionate share of assets

Tax considerations – Grantor Trusts *(cont'd)*

- Entity-level tax
 - None
- Withholding tax – payments to non-U.S. investors
 - Portfolio Interest Exception generally applies only to “registered” (not bearer) obligations
 - Registrar at grantor trust level may allow holders to qualify for Portfolio Interest Exception
- Tax Reporting
 - Widely Held Fixed Investment Trust (“WHFIT”) reporting (1099s)
 - Foreign trusts subject to more stringent reporting

Tax considerations – Partnership

- Entity-level tax
 - None (unless a “publicly traded partnership” treated as a corporation for federal income tax purposes)
- Withholding tax
 - Partnership engaged in a U.S. trade or business must withhold on effectively connected income allocated to non-U.S. partners
- Tax Reporting
 - Schedule K-1

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